OFFICE OF THE CITY AUDITOR
Audit Report

COMPLIANCE AUDIT: DISBURSEMENTS – PAYMENT AUTHORITY

March 21 2012
Stockton, California
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AUDIT SUMMARY

In accordance with our 2010-2011 audit plan, we have completed an audit of City Disbursements, focusing on Payment Authority. This was to be a limited scope audit of the function. In light of recent developments, the Office of the City Auditor has decided to conduct an audit of the Payment Authorization Verification Process.

The objective of our audit was to assess the design and operation of internal controls, and to perform compliance testing of Payment Authority. The scope of our audit included procedures in place and payment transactions for the calendar year 2010.

The City Charter requires all purchases exceeding a set dollar amount to be reviewed and approved by the City Council. For the fiscal year ending June 30, 2010, the amount was $30,224. In recent months, certain contracts have been brought in front of the City Council for ratification. This ratification of expenditures has led to questions on the process used to verify authority for payments to vendors and the role of Accounts Payable in the process.

We conclude that ambiguity in the language of the City Charter has made application of the Council expenditure threshold inconsistent and compliance difficult. We found that the Accounts Payable unit was unsure of its role as an internal control point. During compliance testing of transactions, we observed several instances of non-compliance with City Charter, and policies and procedures. Areas that we believed were system weaknesses, and/or instances of non-compliance, were communicated to management with our recommendations for improvements. Additional information is presented in the Audit Report.

BACKGROUND

The City Charter requires that all contracts and expenditures over an established dollar amount be authorized and approved by an action of the City Council. There are several policy documents that have been created by management intended to clarify the application of this requirement. Despite attempts at clarification, the Council threshold continues to be applied inconsistently.

Earlier this fiscal year, three resolutions went to City Council asking for ratification on prior unauthorized expenditures. These included Temporary Staffing Services, membership expenses with California League of Cities, and External Audit Work. In the first case, the contracts had expired several years ago, yet services were retained
by staff. The second was a case of failing to take the action to Council from the very beginning, and the last was using the contract in excess of the approved authority. A total amount of $1.5 million was ratified under these three Council resolutions (11-0050, 11-0065 and 11-0095) due to violation of the Council Spending Authority limit as prescribed by the City Charter. Management had questions regarding the disbursements process used to verify payments made to vendors and the role that Accounts Payable has in verifying proper authorization to make a payment.

Accounts Payable unit is a part of the Administrative Services department and works under the supervision and direction of the Chief Financial Officer. The following organization chart provides an outline of the staff in the Accounts Payable Unit and the reporting hierarchy.

The Accounts Payable (AP) unit processes payments on all transactions conducted by the City. The volume of the transactions exceeds 65,000 annually resulting in approximately 16,000 payments. The process calls for departments to prepare forms to initiate these payments. The AP unit’s role is perceived by departments to be the control and verification on the legitimacy of the requested payments. AP acts as the final processing unit before funds are disbursed.

OBJECTIVES AND SCOPE

The Audit Plan for fiscal year 2010-11 included an audit of City disbursements. This was to be a limited scope audit of the function. In the recent months, City Council has been asked to ratify certain expenditures that exceeded the City Manager’s spending authority. The Office of the City Auditor decided to focus the Disbursements audit on the Payment Authorization Verification Process to
The focus of the Audit was on purchases made on “Authorization for Payment”.

Purchases made using purchase orders were not included.

determine if the needed ratifications were anomalies, or an indicator of system problems. Our audit objectives were to assess the design and operation of internal controls related to processing payments and spending authority, and to determine if transactions were processed in compliance with the City Charter, and policies.

The scope of our audit included procedures in place and payment transactions made of Payment Authorizations for the calendar year 2010.

**METHODOLOGY**

To gain an understanding of the payment authority process, we reviewed City Charter, policies and procedures, and other relevant documentation. We also asked the Office of the City Attorney to review the above mentioned documents and provide clarification on certain language that we concluded was ambiguous.

With participation from employees involved in each aspect of Accounts Payable, we facilitated Rapid Work Flow Process sessions. These sessions allowed us to document our understanding of the process quickly, document internal controls, identify problems, and develop possible solutions.

We distributed a survey to similar municipalities to identify industry best practice. The municipalities surveyed included cities of Berkeley, Fresno, Bakersfield, Tracy, Sacramento, Manteca, Modesto, Fremont, and counties of San Joaquin and Sacramento.

We also conducted compliance testing on transactions made during the calendar year 2010. The City processed over sixteen thousand payments during the year. Over thirteen thousand payments were processed using the City’s Purchase Order program. The remaining three thousand payments were the focus of this audit. We conducted several tests to assess if the payments were made in compliance with City policies, and whether these policies were reflective of the City Charter requirements. We also looked for internal controls in place to deter abuse or fraudulent activities.

Where issues were observed, we communicated them to City management with our recommendations for improvement. We also provided management a memo listing suggestions for improvement. Management suggestions are opportunities to make system improvements. Unlike reportable findings, management is not asked to submit corrective action plans related to suggestions, and formal audit follow-up is not performed.
We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

RESULTS

We conclude there is ambiguity in City Charter language, leading to inconsistent application of the City Charter defined payment authority. While attempts have been made by management to provide supplementary direction on the application, the policies are unclear and at times contradictory to each other.

Results of the survey conducted on similar municipalities showed that all respondents viewed their Account Payable function as a center for compliance and regulation, and not just a processing center. A summary of the results is tabulated below.

<table>
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<th>SURVEY RESULTS</th>
<th>City of Stockton</th>
<th>Survey Average</th>
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</thead>
<tbody>
<tr>
<td>Response Received</td>
<td>N/A</td>
<td>7 of 10</td>
</tr>
<tr>
<td>Size of Accounts Payable Unit</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Population of Municipality</td>
<td>292,133</td>
<td>359,518</td>
</tr>
<tr>
<td>Number of Checks/payments Issued</td>
<td>16,000</td>
<td>24,277</td>
</tr>
<tr>
<td>Role of Accounts Payable Unit</td>
<td>Processing Center</td>
<td>Processing &amp; Control</td>
</tr>
<tr>
<td>Council Threshold</td>
<td>$20,000 + annual COLA</td>
<td>$31,000</td>
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We performed compliance testing on payment transactions processed in calendar year (CY 2010). We subjected the data to a series of tests. The data was first divided into purchases made on Purchase Orders or Authorization of Payment (AFP). The focus of our testing was payments made on AFPs. We looked at all single transactions that exceeded the Council threshold for proper authority in the sporting documentation maintained by Administrative Services.
We also looked at aggregate purchases that were made by a single department, for a single business need, from a single vendor that exceeded the threshold. The results showed that several aggregate purchases did not meet the intent of the Charter and City policies.

We also found approximately 9% of the payments made did not have sufficient evidence of authority maintained in the system. However, upon further investigation we found that 4% of these were legitimate purchases and evidence had been stored at the department level. The remaining 5% were determined as being out of compliance. The detail on the out of compliance transactions are part of the findings below. The breakdown of the number of payments is as follows:

Finding: Council threshold has been interpreted and applied inconsistently

The Council threshold as described by the City Charter and the Stockton Municipal Code is ambiguous and has been inconsistently applied.

City Charter requires all purchases exceeding a set dollar amount to be reviewed and approved by the City Council. For FY 2010-11 the amount was $30,224. There is uncertainty as to whether the threshold application should be based upon dollar amount: per contract, per vendor, per year, or in some other way. Based on a clarification provided by the Office of the City Attorney, the Charter should be applied to cumulative purchases made from the same vendor.
Staff time is consumed when there are questions about the City Charter requirements. Non-compliant purchases may occur, even when unintended.

**Management Action Plan:** The department staff will develop and submit a policy for City Council consideration that will provide City Council with an opportunity to document its interpretation of existing charter language and provide clear direction to staff with respect to purchasing limits.

**Target Date for Corrective Action:** June 30, 2012

**Finding:** Blanket purchase orders are issued without use of a competitive process

Vendors that are provided with blanket purchase orders are added to the list of blanket vendors at the request of City departments. In addition, there is no documented dollar limit for transactions.

Purchasing Manual (1) states: "Requests for new monthly blanket vendors may be made with the Purchasing Division," and that "No single purchase may exceed the dollar limit established for that vendor."

Absent clarity in City Charter, staff has treated blanket purchase order activity as separate transactions, which would not require City Council action. Separate transaction limits for each blanket vendor have not been documented, as required by the City’s purchasing manual. Significant expenditures of public funds are made annually, without the benefit of City Council approval, and reduce public exposure of financial activity.

There is no documented level of dollar limits for transactions. Per Purchasing, it is set at $500, per day, per employee. Blanket purchase orders created in the financial system are set at $50,000 each. However, if the amount is reached within a year, the purchase order is increased by Purchasing. The lack of dollar limit provides Purchasing with authority to go over the City Council threshold. We identified 12 vendors where the aggregate purchases made were in excess of this authority.

Most blanket vendors are local, so there is a missed opportunity for the City Council and the public to see public funds being spent locally.

**Management Action Plan:** Management believes that the blanket purchase orders provide efficient access to approved and monitored vendors who support City operations with numerous small supply

Under the blanket purchase order program significant expenditures of public funds are made annually, without the benefit of City Council approval.
and services transactions throughout the fiscal year. Staff has operated under an interpretation of the charter provision that considers individual supply orders to be separately measured against the charter purchasing limit as individual transactions. The current practice of combining multiple small purchases into a single blanket purchase order provides a time and labor cost-benefit to the City by eliminating hundreds of Purchase Orders. Management does concur that the City’s Charter language is ambiguous, and will propose a policy for City Council’s consideration that clarifies the Council’s interpretation and delegation of purchasing authority.

We concur that payments for one vendor did not comply with purchasing authority. This vendor was consistently exceeding the limit set by purchasing and therefore, purchases have been migrated to the normal purchase order process since March 2011.

The management will also take the following actions to correct the condition:

- Staff will develop and submit a policy for City Council consideration that will provide City Council with an opportunity to document its interpretation of existing charter language and provide clear direction to staff with respect to purchasing limits. This clarity will facilitate compliance with the Charter and Council policy.

- The full list of blanket purchase order vendors will be evaluated for current use and activity; recommendations to departments will follow if any services should be migrated into newly bid contracts.

- Administrative Directive Contracts 25 will be updated to document the blanket purchase order single transaction limit of $500 per employee per vendor per day, or other limit established by City Council through the proposed Council Policy discussed above.

- Daily employee transaction limits will also be communicated annually to the Blanket Purchase Order Vendors in the instructions issued to participants each fiscal year. Vendors are currently notified and acknowledge the spending limit during the annual registration process.

**Target Date for Corrective Action:** August 15, 2012
Finding: Blanket purchase order program does not define business need for authorizing employees to make purchases

Purchasing Manual (1) states: "Only authorized City employees may use the monthly blanket purchase order." The manual does not have a defined criterion of who should be authorized to make the purchase based on business need. In practice, every employee, past or present, that has a City issued ID card, is able to make a purchase at any of the vendors in the Blanket Purchase Order program.

Unlike the Procurement Card program, there is no disciplinary policy for abusing the program. Unauthorized purchases can cause the City a loss of funds. It also wastes staff time researching and correcting any misuse of the program.

Management Action Plan: Management concurs with the findings. However, no infractions of improper employee purchases have been identified as part of this audit.

The management will also take the following actions to correct the condition:

- Update Administrative Directive Contracts 25.1.g (Monthly Blanket PO) to address criteria for authorized users based upon business need, and provide names of authorized users to vendors participating in the program.
- Evaluate the City’s existing disciplinary process to consider if it is sufficient to address any abuses of the Blanket Purchase Order program.
- Post on-line training for employees on the Purchasing intranet page.

Target Date for Corrective Action: June 30, 2012

Finding: Requirement for obtaining price quotes on open market purchases is ambiguous

The requirement to obtain price quotes "whenever practical" for open market purchases is ambiguous and can be interpreted differently by staff.

Purchasing Manual (2) states: "Open market purchases of supplies, materials, services and equipment which exceed Five Thousand Dollars ($5,000) shall, whenever practicable, be based on at least
three price quotations and shall be awarded on the basis of the price quotation most advantageous to the City." The City makes numerous purchases over $5,000 each, but below the Council threshold.

While researching transactions for the calendar year 2010, we only found one instance that was documented with three price bids. Absent evidence of a competitive process, it is impossible to determine if the City is getting the best deal when purchasing goods and services under the City Council threshold.


Target Date for Corrective Action: June 30, 2012

Finding: Annual fuel contract is bid and awarded at staff level without Council approval

Annually, the City seeks bids for the purchase of fuel. Current usage exceeds $1.5 million a year. City staff seeks the bids, evaluate the responses, and award a contract. City Council does not approve these purchases.

In 1989, the City Council delegated its responsibility to approve fuel purchases exceeding the City Charter limit to City staff (resolution 36851). Staff was directed to conduct administrative bids in subsequent years and award a contract to the low bidder. The City Council action in 1989 appears inconsistent with City Charter language, effective January 1, 2001.

Fuel is a major expense in the current economy. For the last 3 years, the same vendor has been awarded the contract for the City’s needs, without being approved in a public setting by the City Council.

Management Action Plan: While management has followed City Council direction to conduct a formal competitive bid for fuel providers on a yearly basis and to award the contract to the best price vendor, they feel that through this resolution, Council has delegated this contract authority to staff.

Consistent with the Action Plan for other findings, staff will develop and submit a policy for City Council consideration that will provide City Council with an opportunity to document its interpretation of existing Charter language and provide clear direction to staff with respect to purchasing limits. This clarity will facilitate compliance with the Charter and Council policy.
An update of the existing fuel purchase authority resolution will be brought forward to City Council for their current consideration.

**Target Date for Corrective Action:** June 15, 2012

**Finding:** Most employee benefit contracts are renewed at staff level based on provision made at time of the contracts.

The City has several employee benefit contracts with no expiration date or with provisions giving staff authority to renew indefinitely. This circumvents Council authority to approve expenditures.

We found that several contracts related to employee benefits were established a significant time ago and have either (a) no expiration dates, or (b) give staff the authority to renew on a periodic basis.

These contract terms appear contrary to the Council’s Charter bound authority to approve all contracts over a specified amount. City Charter authority for expenditures has been inconsistently applied, due in part to ambiguity in the language of the Charter and resolutions adopted. The contracts are clearly out of compliance of the Charter rules and City adopted directives. The long term contracts may not be providing the best price in the current market, and staff has no way of evaluating without bids.

**Management Action Plan:** The Human Resources department will seek Council approval to issue a Request for Proposal for all vendors named. This plan was previously brought to Council’s attention in a Strategic Initiative. The vendor contract Request for Proposal Business Plan was proposed to and accepted by the City Council on May 17, 2011.

**Target Date for Corrective Action:** March 31, 2013

**Finding:** Accounts payable staff is able to create new vendors in the Financial System

Accounts Payable staff has access to both create new vendors and make payments using the City's electronic financial system, which increases the City’s risk of unauthorized transactions.

Not all vendors pass through the Purchasing Division in the normal course of business. Some go directly from departments to Accounts Payable, who then creates a vendor record in the electronic system. The risk of inappropriate expenditure transactions increases.
A basic internal control calls for a separation of duties between staff that sets up vendors and those that are authorized to make payments.

**Management Action Plan:** Management agrees that separation of duties is an essential control in the disbursement process. Vendor files maintenance, including name and address changes, requires active integration with the disbursement process to avoid undue processing delays. Due to limited staff resources in both Purchasing and Accounts Payable, this action may require the shifting of staff and duties between divisions to achieve this important control.

The management will implement separation of duties and differentiate system access between those employees performing Accounts Payable vendor file maintenance activities and those processing disbursements.

**Target Date for Corrective Action:** June 30, 2012

**Finding:** Charter does not clarify if the threshold is applicable by single or cumulative transactions

The City has several vendors that are routinely used for purchases exceeding $30,224 in a single year. For one of the vendors, individual transaction amounts exceeded the $30,224 limit, which requires City Council approval. In other cases, individual transactions were less than the City Council threshold, and due to ambiguity of City Charter language, it is unclear if these transactions required City Council approval. These vendors are paid using the City’s Authorization for Payment process and no contracts are established for them.

Due to inconsistent application of the City Charter required threshold, significant expenditures have been made without City Council approval that includes evidence of a competitive process, or a determination that use of a sole source provider is appropriate.

**Management Action Plan:** Management purchasing authorization has been benchmarked on individual purchases, rather than aggregate or annual cumulative spending. However, the Charter language is ambiguous and that development of a City Council policy to interpret this language would facilitate compliance with the City Council’s intent.

Management also concurs that payments to one of the vendors exceeded the Council purchasing limit.
Following are the actions that will be taken by management:

- Develop and submit a policy for City Council consideration that will provide City Council with an opportunity to document its interpretation of existing charter language and provide clear direction to staff with respect to purchasing limits. This clarity will facilitate compliance with the Charter and Council policy.

- Issue an RFP for services provided by Universal Building Services & Supply and submit incurred expenditures to City Council for ratification.

- Schedule semi-annual review of vendor purchases that aggregate over the $30,224 City Council limit to determine if related transactions should be grouped and approved into single authorization by City Council.

**Target Date for Corrective Action:** June 30, 2012

**Finding:** Contractors have been hired based on an informal vendor pool

Several contractors have been hired and paid in excess of the Council limit during the year, without established contracts, based on an informal vendor pool approved by the Purchasing.

The City hires contractors to provide services on abandoned properties. These services include boarding-up, cleaning, maintenance, debris removal, etc. A list of vendors has been established and approved by the Purchasing for these types of services used by the Code Enforcement Unit. Also, all vendors are paid in excess of the City Council threshold.

Due to inconsistent application of the City Charter required threshold, out of compliance purchases have been made by department. List established by Purchasing has not been approved by Council as a vendor pool.

**Management Action Plan:** Management concurs with this finding. Department staff will submit a newsletter to Council approving appropriate vendor pools for future activity, in the areas of 24-Hour Emergency Board Up and Abatement.

We note that these transactions could meet purchasing criteria if three bids are obtained for purchases between $5,000 and the Council limit, on a transaction or project basis. However, in practice,
these vendors have been selected from an informal vendor list rather than from a Council-approved vendor pool, without three quotes, and on a rotational basis.

**Target Date for Corrective Action:** June 30, 2012

**Finding:** Transactions have been processed without adequate evidence of documented authority

Roles and responsibilities for ensuring proper authority to expend funds have not been established and documented. Absent established roles and responsibilities, there is an expectation gap between the Accounts Payable unit and operating departments. Each views the other as responsible for verifying authority.

Transactions have been processed, and funds expended without documented authority. In some cases, authority given to the City Council in the City Charter has been exercised by City staff.

According to Evaluating Internal Controls, A Local Government Manager’s Guide (GFOA, 1996, p. 73), an overall objective of the resource outflow cycle is that “authorization to purchase supplies and services should be reflected in the accounting records.”

A survey conducted by the Office of the City Auditor on similar municipalities showed that all respondents viewed the role of Accounts Payable to be both “Processing Center” and “Regulatory & Compliance” check point.

While conducting research, we found payments made to 67 vendors were not adequately supported. Additional examination revealed that of those, 51 were actually authorized, but the authority had not been properly documented in disbursement packets. Authority for the remaining 16 vendors is inadequate. These vendors are also discussed in other findings.

**Management Action Plan:** The expectation for Accounts Payable as a compliance check point has appropriately been expanded. Steps have already been implemented to expand the review and testing of Accounts Payable transactions prior to disbursement. Specifically, the following controls have been implemented to address this objective:

- All disbursements over $10,000 are submitted for a second, supervisory review.
All purchases made outside of the normal purchase order system are subject to 100% supervisory review.

Non-compliant payment requests are sent to Purchasing for further review, correction, department outreach, and training.

Purchasing will also revise Administrative Directive Contracts 25 to clarify Accounts Payable processing procedures and controls.

**Target Date for Corrective Action:** June 30, 2012

**AUDITOR’S COMMENTS**

The ambiguity in City Charter language has lead to several inconsistent applications of the City Charter defined payment authority. Staff has relied on several interpretations provided by management.

We recommend that the City Council supervise and review the policy recommendations made by staff to interpret and clarify the language of the threshold, and adopt a Council Policy on the subject.

The significance of the resulting document Policy will facilitate compliance with the Charter and Municipal Code on all future spending.
**DISTRIBUTION**

Mayor and City Council  
Bob Deis, City Manager  
John Luebberke, City Attorney  
Bonnie Paige, City Clerk  
Laurie Montes, Deputy City Manager  
David Millican, Interim Chief Finance Officer  
Connie Cochran, Public Information Officer  
Maze & Associates  
The Record

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(1) Purchasing Manual Monthly Blanket PO - CONTRACT.25.1g  
(2) Purchasing Manual CONTRACT.25.1i
CITY AUDITOR MISSION STATEMENT

The Office of the City Auditor independently promotes ethical, efficient and effective governance for the citizens of Stockton. We provide the City Council, management, and employees with objective analyses, appraisals, and recommendations for improvements to City systems and activities. The department maintains independence and objectivity by reporting directly to the City Council and by not exercising direct authority over any department, system, or activity subject to audit.