



Bill Perrone, CIA  
Manager, Internal Audit

October 5, 2009

Assignment 10186

To: Distribution List

Subject: Internal Audit Report: Direct Pay Code Process – Internal Controls

We have completed an audit of the direct pay code process. We conducted the audit from November 2007 through May 2008.

Respectfully submitted,

Signature on file

Bill Perrone, CIA  
Manager, Internal Audit

Distribution List:

John V. Guthrie, Director, Finance Agency  
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Board of Supervisors  
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**Internal Audit Report**

**Direct Pay Code Process –  
Internal Controls**



Assignment 10186  
October 5, 2009

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## Executive Summary

**Conclusion** In our opinion, the current Direct Pay Ordinance does not effectively meet the current County business needs. There is also a need to structure the ordinance to identify potential contractual vendors and eliminate ambiguous codes.

At the exit interview, the Disbursements Division Manager and the Procurement Director agreed that the report was factually accurate.

**Audit Objectives** The audit objective is to evaluate the business needs for the Direct Pay Ordinance and ensure that the direct payment process has efficient and effective internal controls.

**Audit Scope** The scope of the audit included:

- Evaluating the existing controls that minimize improper use of the direct pay thereby increasing the liability and proper costing risks.
- Evaluating the existing controls that help identify potential contractual vendors.
- Reviewing the Direct Pay Ordinance for clarity.
- Analyzing the effect of the direct pay codes on the proper recording of transactions into the general ledger.
- Evaluating the Direct Pay Ordinance’s familiarity among users.
- Reviewing the payment approval process.

The FY07 vendors’ payable files, which totaled \$2.5 billion, provided the data used in this audit’s testing procedures.

**Audit Background** We selected the direct pay ordinance for audit based upon our FY08 macro risk assessment. We conducted our audit in accordance with the International Professional Practices Framework as established by the Institute of Internal Auditors.

The Direct Pay Ordinance is to authorize the payment for transactions that are not on purchase orders. It is administered by a committee (known as the Procurement Payment Resource Committee (PPRC)) comprised of the Office of the County Counsel, Procurement, Controller-Treasurer, and Internal Audit. The committee is staffed by the Disbursement Manager, the Procurement Director, the Internal Audit Manager, and a representative from the Office of the County Counsel. In FY07, approximately \$2.5 billion was processed through the Direct Pay Ordinance.

Details about our findings and recommendations are provided below.

Signatures on file

Bill Perrone, CIA  
Manager, Internal Audit

Brian P. Mark, CIA  
Sr. Internal Auditor

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## Findings and Recommendations

### Finding 1

#### **The current Direct Pay Ordinance does not effectively meet the current County business needs.**

With the advent of the current enterprise resource planning system in 2003, the County decentralized its accounts (vendor) payable function. The current ordinance was designed for a "centralized release of payments" structure, one that no longer exists in the County. The current ordinance permitted the Controller-Treasurer's accounts payable personnel to verify the reason for paying an invoice before releasing an invoice for payment. This documentation is now self-contained at the respective departments and the Controller-Treasurer's Office no longer releases individual invoices for payment.

Presently, the County's accounts payable clerks at the departments assign a code to each direct payment transaction; they must select one code from the ordinance's 104 codes. In 2007, the Controller-Treasurer surveyed other counties' direct pay practices. Of the responding counties, six maintain a direct pay structure containing less than 20 codes; one county's structure has less than 50 codes. Only Santa Clara County retains a structure exceeding 50 codes. A noteworthy finding, Los Angeles County manages its direct payments with 16 codes.

In this decentralized environment, the County departments employ the accounts payables clerks. The current direct pay code descriptions do not provide any informational benefits to these departments. Responding to our survey all 13 departments stated they use the general ledger accounts, not the direct pay data, for managerial purposes. Only the Controller-Treasurer utilizes direct pay code data.

An ordinance must serve a useful purpose and should not be burdensome to implement. Although the County departments do not derive benefits from this ordinance, the Controller achieves its payment monitoring and analysis functions partially with direct payment codes. The ordinance, therefore, serves a purpose, but it may not meet the County's business needs.

While experienced accounts payable clerks may know the codes they frequently use, inexperienced clerks need to check the ordinance more frequently while processing payments. Processing time can be reduced with a simplified ordinance. As a result of research done by the Procurement Payment Resource Committee, the Controller is considering deleting 23 idle codes thus justifying a revised ordinance. A more simplified ordinance could better serve the

County's business needs.

93.9% of the dollars flowing through the direct pay process relates to the County being a fiscal agent and there are no opportunities to control County expenses. Appendix A recaps the FY07 direct pay expenditures by groups of Non-county Entities, Distributions, County Specific Expenditures, and County Miscellaneous Expenditures. As Appendix A shows, 93.9% of the dollars flowing through the Direct Pay Ordinance are for expenditures where the Direct Pay Ordinance cannot control County expenses (91.1% Distribution of Funds and 2.8% Non-county entities).

In summary, 104 direct pay codes are being used to process \$2.5 billion of payments, but the Direct Pay Ordinance has the potential to help the County manage only \$156 million of cost. Appendix B is a proposed direct pay structure that would align direct pay codes with the current business needs of the County. This proposed structure would better permit the County to manage expenses.

#### **Recommendation 1**

Within one month of this report's issuance, the Controller-Treasurer Department should direct the Procurement Payment Resource Committee to simplify the Direct Pay Ordinance structure and complete implementation within six months. Internal Audit recommends the proposed structure in Appendix B be used. For the non-County entities and distributions, Internal Audit recommends these transactions be removed from the Direct Pay Ordinance that is approved by the Board and managed by a process to be established by the Controller-Treasurer. This will permit County management to focus on the approximately \$156M that is pure County expenditures with only ten codes. [Priority 2]

#### **Finding 2**

##### **The current ordinance inhibits identifying potential contractual vendors.**

The direct pay process is not specific regarding the purchase of goods. The "H2A" code is for miscellaneous goods. In FY07, there were 31,313 purchases for \$21,021,659. This involved 3,579 vendors with the high of \$443,382 being paid to one vendor.

Prior to implementing the new accounting system, SAP, in 2003, the central accounting system did not track direct pay codes. In FY07, an edit was programmed into SAP to require a valid direct pay code. Prior to FY07, the system did not have the ability to identify the activity under Code H2A. Now that there is the ability to identify the transactions, it permits the County to utilize better procurement techniques such as master contracts and procurement cards. For the vendors with high total dollars, it may warrant having a master

contract where the County can obtain pricing discounts. For the many vendors with low total dollars, it may be beneficial to encourage procurement card usage in order to reduce the administrative cost of processing the transactions.

**Recommendation 2** The Procurement Director should annually review the data for possible contracts with large dollar vendors and take steps to encourage the use of procurement cards for the remaining purchases. The reports can be generated from SAP to assist with this recommendation. [Priority 1]

**Finding 3** **Certain code descriptions are ambiguous and are subject to misapplication.**

For departments to properly apply a direct pay code to a disbursement transaction, the ordinance's code descriptions need to be clear and comprehensive. When these two characteristics are lacking, the code identification process becomes subjective; thus the departments are more apt to miscode transactions.

Code "A" and codes "H2B," and "H2C" are prime examples of ambiguous codes.

The September 2005 ordinance established code "A" for "incidental payments or fees necessary to implement a Board approved contract, policy or project not otherwise provided for by Board action, that does not require the procurement of goods or services." In practice, departments use this code to record debt service payments (for which the ordinance lacks any appropriate code), payments to other governmental entities and other expenditures for which they are unclear.

Codes H2B, and H2C exist to record the purchase of services not covered by contracts provided the total cost does not exceed certain specified amounts. These amounts are \$2,500 for corporate vendors and \$1,000 for non-corporate vendors. The difference justification is not mentioned in the ordinance. The ordinance does not state if these cost limitations apply to single purchases or to the total annual purchases by vendor. Codes H2B and H2C apply to services purchases and they impose different limitations depending upon the vendor's corporate status.

**Recommendation 3.1** Within one month the Controller-Treasurer Department should direct the Procurement Payment Resources Committee to come up with clear and unambiguous codes in the next six months. The recommendation should include approvals by dollar thresholds. [Priority 1]

**Recommendation 3.2** Within one month the Procurement Department should direct the Procurement Payment Resource Committee to make the following changes: [Priority 1]

- Combine “H2B” and “H2C”
- Eliminate the different dollar thresholds on “H2B” and “H2C”

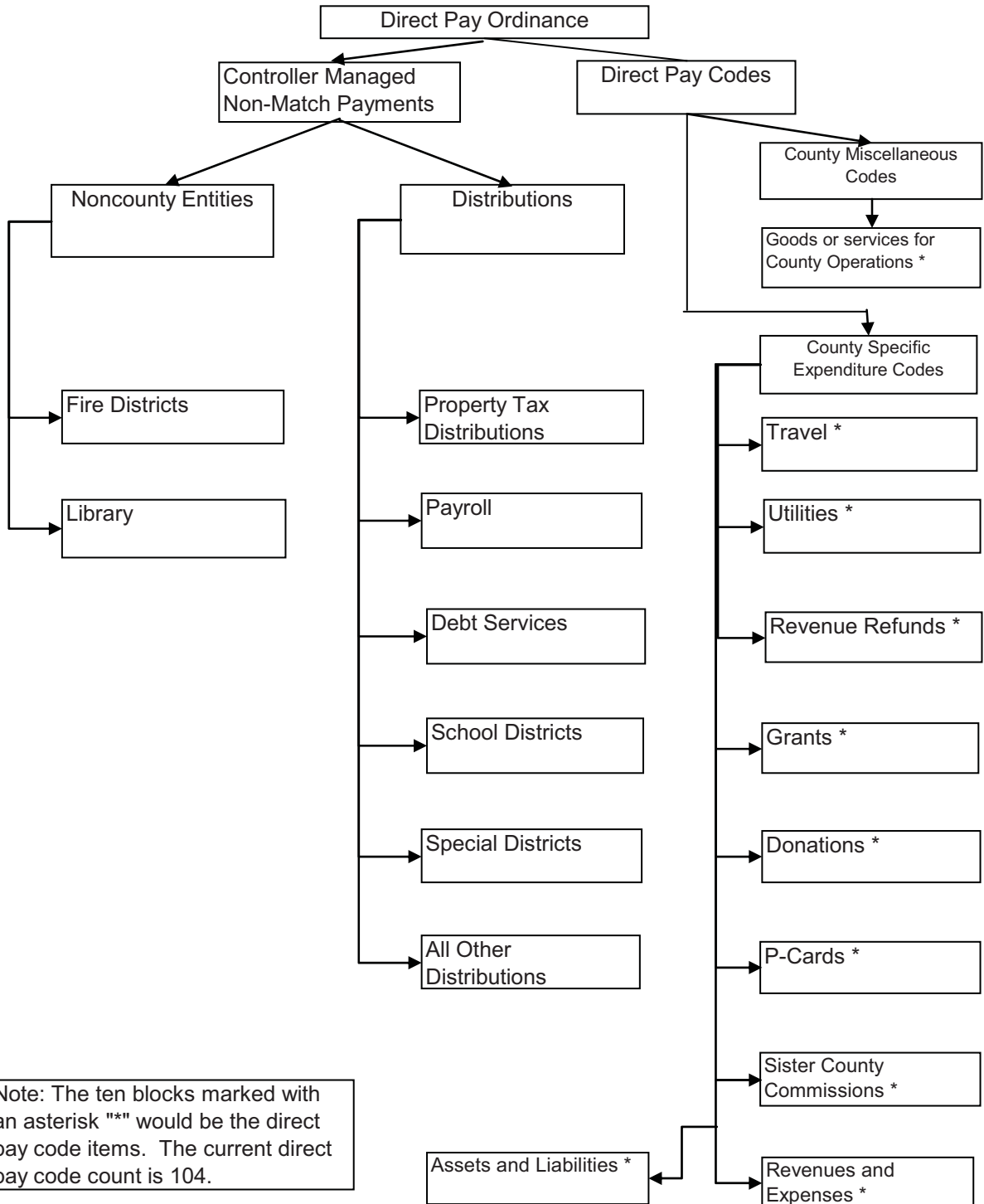
## APPENDIX A

## FY07 EXPENDITURES ASSOCIATED WITH PROPOSED ORDINANCE

| Category                             | Description                 | Transaction<br>Quantity | Amount        | Percent |
|--------------------------------------|-----------------------------|-------------------------|---------------|---------|
| Non-county entites                   | fire districts              | 3,935                   | 21,719,379    |         |
|                                      | library                     | 3,823                   | 3,423,560     |         |
|                                      | superior court              | 10,160                  | 45,849,445    |         |
|                                      | subtotal                    | 17,918                  | 70,992,384    | 2.8%    |
| Distributions                        | property tax                | 817                     | 1,048,799,568 |         |
|                                      | payroll                     | 5,188                   | 300,729,904   |         |
|                                      | debt service                | 293                     | 360,264,672   |         |
|                                      | school districts            | 194                     | 260,401,988   |         |
|                                      | special districts           | 26                      | 2,129,545     |         |
|                                      | other distributions -- govt | 2,062                   | 332,227,635   |         |
|                                      | other distributions         | 418                     | 3,362,758     |         |
|                                      | subtotal                    | 8,998                   | 2,307,916,070 | 91.1%   |
| County Specific<br>Expenditure Codes | travel                      | 6,637                   | 2,745,064     |         |
|                                      | utilities                   | 22,296                  | 31,945,050    |         |
|                                      | revenue refunds             | 4,891                   | 8,212,190     |         |
|                                      | grants                      | 25                      | 5,681,014     |         |
|                                      | donations                   | 4                       | 16,300        |         |
|                                      | p-card                      | 13                      | 7,122,524     |         |
|                                      | sister County commissions   | 9                       | 85,878        |         |
|                                      | rev and exp -- VHP          | 14,859                  | 25,520,274    |         |
|                                      | rev and exp -- CSAC         | 13                      | 10,977,132    |         |
|                                      | rev and exp -- Other        | 26,304                  | 37,770,847    |         |
| subtotal                             | 75,051                      | 130,076,273             | 5.1%          |         |
| County Miscellaneous Codes           | goods (H2A)                 | 31,313                  | 21,021,659    |         |
|                                      | services (H2B and H2C)      | 8,082                   | 4,577,629     |         |
|                                      | subtotal                    | 39,395                  | 25,599,288    | 1.0%    |
| Total FY07 Direct Pay Charges        |                             | 141,362                 | 2,534,584,015 | 100.0%  |

APPENDIX B

PROPOSED DIRECT PAY ORDINANCE



Note: The ten blocks marked with an asterisk "\*" would be the direct pay code items. The current direct pay code count is 104.

# County of Santa Clara

Finance Agency  
Controller-Treasurer Department

County Government Center  
70 West Hedding Street, East Wing 2<sup>nd</sup> floor  
San Jose, California 95110-1705  
(408) 299-5200 FAX 289-8629



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**Date:** October 2, 2009

**To:** Bill Perrone, Internal Audit Manager

**From:** Irene Lui, Division Manager – Disbursement and Property Tax

**Re:** Response to Direct Pay Code Audit Findings and Recommendations

We appreciate the opportunity given to respond to the audit of the Direct Pay Code Process. This memo outlines our responses to your audit recommendations.

## Recommendation 1

Within one month of this report's issuance, the Controller-Treasurer Department should direct the Procurement Payment Process Review Committee (PPPRC) the need to simplify the Direct Pay Ordinance structure and complete implementation within six months. Internal Audit recommends the proposed structure in Appendix B be used. For the non-County entities and distributions, Internal Audit recommends these transactions be removed from the Direct Pay Ordinance that is approved by the Board and managed by a process to be established by the Controller-Treasurer. This will permit County management to focus on the approximately \$156M that is pure County expenditures with only ten codes.

## Department Response

We agree that the current direct pay structure needs to be simplified on the condition that proper internal control procedures are in place under our decentralized environment – so that only “true” direct pay are processed as non-match transaction.

Simplifying the Direct Pay Ordinance has already been an important task to the PPPRC since 2007, that we have held regular meetings for the past two years. We conducted county survey, and performed extensive research and analysis on the non-match SAP payment process governed by our direct pay ordinance. We identified some direct pay codes that were dormant for years, and communicated with department fiscal officers to eliminate such codes in last fiscal year.

The Direct Pay Ordinance has been in place for decades. Due to the large volume of direct pay transactions and number of departments involved, the recommendation for such a significant change, that we believe is beneficial to the county for the long run, however, may cause inefficiencies and/or interruption of normal operations if not well planned. Therefore, instead of a complete implementation at your specified time period, the PPPRC will gather feedbacks from departments, seek for feasible solutions, and bring in the proposed (simplified) direct pay code list to the Board for approval by June 2010.

### **Recommendation 3.1**

The Controller-Treasurer's Disbursement Manager should direct the PPPRC to come up with clear and unambiguous codes in the next six months. The recommendation should include approvals by dollar thresholds.

### **Department Response**

We agree with the recommendation.

Over the years, direct pay code "A" – which was intended to be used for only incidental payments or fees necessary to implement a Board approved contract, policy or project not otherwise provided for by the Board action – has become the most easily picked direct pay code by departments with huge number of payments that do not match the description.

We noticed other codes that are subject to misinterpretation and should also be eliminated or revised. Together with Recommendation One for a simplified direct pay ordinance, the PPPRC will work with respective departments to submit the proposed codes for the Board's adoption. In order to prevent possible misuse and to improve the control and monitoring of these non-match payments, we will include the recommended control procedures or activities when we submit the proposed simplified codes.



## County of Santa Clara

Office of the County Executive  
Procurement Department


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San Jose, CA 95131-1040  
(408) 491-7400 Fax (408) 491-7496

October 2, 2009

TO: Bill Perrone, Internal Audit Manager

FROM: Jenti Vandertuig, Director of Procurement

SUBJECT: Response to Direct Pay Code Audit Findings and Recommendations



I appreciate the opportunity to respond to the audit of the Direct Pay Code process. This memo outlines my response to your audit findings.

The Procurement Department concurs with Finding 2 – the current ordinance inhibits identifying potential contractual vendors and Finding 3 – certain code descriptions are ambiguous and are subject to misapplication. We are also in agreement to work with the Direct Pay Committee to make the necessary changes to the Direct Pay Ordinance.

While the scope of the audit is limited to the Direct Pay Process – Internal Controls, the Director of Procurement has recognized the need to review the entire Direct Pay Ordinance and determine the risk of continuing to use this method as an informal acquisition process. It is the intent of the Procurement Department to work with the Office of the County Counsel to assess the risk with the current methods and provide alternate acquisition processes like the use of the Procurement Card and/or Field Purchase Orders. A recommendation will be made to the County Executive and the Direct Pay Committee.

Under the California Commercial Code Section 2201.(1), purchases over \$500 are not enforceable without a written agreement. Our Direct Pay authority limits range from \$2,500 to unlimited amounts for certain codes which poses a risk on how these goods

and services are acquired. Direct Pay codes are incorrectly utilized by departments to pay their invoices, splitting purchases under payment codes that have a dollar limit, and making repetitive purchases in lieu of working with the Procurement Department to establish contracts utilizing economies of scale are other reasons why the Direct Pay Ordinance should be used only as a payment method and not used for the acquisition of goods and services for County operations.