

# Summary Minutes Audit Oversight Committee

REGULAR MEETING OF THE AUDIT OVERSIGHT COMMITTEE  
ORANGE COUNTY, CALIFORNIA



*Thursday, February 28, 2008, 11:00 a.m.*

HALL OF ADMINISTRATION  
333 Santa Ana Blvd, 5<sup>th</sup> Floor  
Conference Room B  
Santa Ana, California

TELECONFERENCE LOCATION: IHS, Inc.  
10955 Westmoor Drive, Suite 335  
Westminster, Colorado 8001

**Supervisor John Moorlach**  
Member

**Supervisor Patricia Bates**  
Member

**David Sundstrom**  
Chairman

**Thomas G. Mauk**  
Member

**Dr. David Carlson**  
Vice Chairman  
Public Member

**Chriss Street**  
Ex-Officio Member (non-voting)

ATTENDANCE: John Moorlach, David Sundstrom, Thomas Mauk, Chriss Street,  
Dr. David Carlson,

EXCUSED: Patricia Bates

PRESENT: Director, Internal Audit Department: Dr. Peter Hughes  
County Counsel Benjamin de Mayo  
Clerk: Renee Aragon

**11:00 A.M.**

1. Roll Call  
Guests: Internal Audit Staff: Eli Littner, Alan Marcum, Autumn McKinney, Michael Goodwin, Camille Gackstetter; Auditor-Controller Staff: Shaun Skelly, Bryan Berea, Claire Moynihan, Toni Smart; County Executive Office Staff: CFO Bob Franz, Faye Watanabe; Treasurer Tax Collector Staff: Paul Gorman; Macias, Gini & O'Connell: Jean Horimoto, Jim Godsey; Third District staff: Louis Bronstein; Second District Staff: Ian Rudge, Fifth District: Elise Lampe; First District: Matthew Harper; Grand Jury 07-08 Member: Tammy Martinez
2. Approve Audit Oversight Committee Minutes of November 7, 2007  
VOTE: Moved-Carlson, Seconded-Mauk, Yes-Sundstrom, Yes-Moorlach, Excused-Bates  
**Approved as recommended.**

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3. Receive communication required in accordance with auditing standards from External Auditor – Macias, Gini & O’Connell (MGO)  
VOTE: Moved-Moorlach, Seconded-Carlson, Yes-Sundstrom, Yes-Mauk, Excused-Bates  
**Received.**

Mr. Jim Godsey addressed the Committee. Referring to the package there were corrections noted to the submission date. The date of the communications was corrected to read December 12, 2007. Also, the audit report date for the Basic Financial Statements was corrected to read December 12, 2007.

Mr. Godsey explained their required communications under auditing standards as stated in the package. It was designed to give the AOC perspective to the nature of scope and standards used for the audit of the current year. MGO had examined the financial statements for Orange County for the fiscal year ending June 30, 2007. MGO issued reports on basic financials dated December 12, 2007, the OC Special Financing Authority dated November 16, 2007, the OC Development Agency dated November 20, 2007, John Wayne Airport dated December 6, 2007, and Integrated Waste Management Department dated November 30, 2007. They were in the final stages of finishing the compliance audit and single audit in accordance with A133 standards for federal financial assistance.

As noted in the package, Mr. Godsey stated their responsibility under generally accepted accounting principles to plan the audit so as to obtain reasonable but not absolute assurance and that the financial statements were free from material misstatement.

MGO had discussions with Management during the past year on the new risk assessment and internal control standards that would become effective in 2008. MGO stated they had discussions with the AOC as well. The new standards require significant additional documentation by management. The auditing standards required the auditors to conduct a much more thorough examination and assessment of Orange County’s internal controls than in the past. It required the County to demonstrate it had adequate controls over its financial statements. MGO anticipated the external auditor would spend significant amount of time in obtaining an adequate understanding and assessment of the County’s controls.

Mr. Godsey referenced the other information and documents containing audited financial statements. MGO did not audit the annual reports but rather validated the financial reports which were included in its entirety. Under significant accounting policies, management was responsible for the selection and use of the appropriate accounting policies. There was no significant or unusual type of transactions that would require mention. The accounting estimates and audit adjustments were discussed and there were no disagreements with management, no consultations with other independent accountants, no issues discussed prior to retention of independent auditors and no difficulties encountered in performing the audit. Mr. Godsey stated there were no unusual difficulties encountered during the course of the audit. The accounting estimates were a critical part of the preparation process for the audit. Mr. Godsey stated MGO was required to disclose to the Committee any audit adjustments that were posted or not posted during the year. There were four adjustments noted on Attachment A, Page 5 of the package.

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During the course of the audit, many discussions with Management occurred at all levels of the County. We were required to present any concerns raised and whether they were resolved satisfactorily or not. During the course of the audit, there was no disagreement noted in the letter. However, Mr. Godsey stated there was potential possible subsequent events that happened subsequent to the June 30, 2007 balance and the audit report date that was discussed later in the meeting (see agenda item 8).

4. Receive oral status of triennial audit of various bargaining unit Memoranda of Understanding Agreements and Amendments for employee withholdings (AOC Meeting 9/5/07, Item 6, 11/7/07, Item 3)  
VOTE: Moved-Moorlach, Seconded-Sundstrom, Yes-Carlson, Yes-Mauk, Excused-Bates  
**Received**

Dr. Hughes provided a status of the audits underway. Mr. Marcum stated they audited the cost allocation for the pension enhancements that were negotiated with OCEA. The objective was to determine whether the OCEA members were picking up the cost for their pension enhancements and were given credit for related health care savings resulting from making higher co-pays and other concessions. The audit conclusion was that the OCEA members were properly picking up the costs and were properly credited for health care savings. Dr. Hughes noted it was a difficult and complex audit. Dr. Hughes said there was tremendous assistance by the CEO/Public Finance and Human Resources Dept. The draft of the report would be issued today or tomorrow.

5. Receive oral status on audit coverage in the Sheriff Department (AOC Meeting 11/7/07, Item 6)  
VOTE: Moved-Sundstrom, Seconded-Moorlach, Yes-Carlson, Yes-Mauk, Excused-Bates  
**Received.**

Dr. Hughes stated the audit focused on the Sheriff and his Command Staff or Sheriff Administration in terms of travel, purchasing card and petty cash transactions and revolving fund activity. Mr. Goodwin stated command staff included the former Sheriff Corona, the Undersheriff, 4 Assistant Sheriffs and 4 administrative support staff. The review was divided into three audits. Two of the three audits were completed and reports were issued. 100% of transactions incurred by or on behalf of Sheriff Administration in those areas were evaluated. No material or significant areas of non-compliance issues were revealed. Mr. Goodwin said they looked for evidence of deviation from standard county procedure or evidence of management override and none were found. The sole-source contracts audit was still in progress. The Sheriff's office has been very cooperative.

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6. Receive and file OC Internal Audit Department Status Report for period October 1, 2007 through December 31, 2007 and Executive Summaries of Audit Finding Summaries for the Period October 1, 2007 through December 31, 2007  
VOTE: Moved-Sundstrom, Seconded-Moorlach, Yes-Mauk, Yes-Carlson, Excused-Bates  
**Approved as recommended.**

Dr. Hughes presented the status report and stated the department was on schedule and on budget. Dr. Hughes noted that the directives of the AOC on the Sheriff's Department audits and the pension audit resulted in other audits being post-poned or cancelled to accommodate the requests of the AOC. Mr. Moorlach requested clarification on page 1, DA worker's compensation audit overage of hours. Mr. Marcum stated that on one of the grants a check worth approximately \$240,000 was missing. Hours were added to track the check and identify the problem. Mr. Marcum stated the DA would be billed for the work. Mr. Moorlach asked about the Apportionment Audit in the Treasurer's office on Page 2, with an overage of 211 hours and was satisfied with the explanation. Mr. Moorlach asked about the Public Finance audit, Page 2, with an 141 hour overage and was satisfied with the explanation.

7. Receive and file External Audit Coverage 2<sup>nd</sup> Quarter Status Report FY 07/08  
VOTE: Moved-Moorlach, Seconded-Mauk, Yes-Sundstrom, Yes-Carlson, Excused-Bates  
**Approved as recommended.**

8. Receive oral update on Treasury Investment Pool SIVs  
Initial VOTE: Mr. Moorlach motioned to receive the oral report, Second-Sundstrom, Yes-Carlson, NO-Mauk, Excused-Bates  
COMMENTS: Mr. Mauk requested perspective and plans for disclosure on the most recent developments. He was not comfortable to receive and file at this time, but wanted to know prospectively what the disclosure language would be for the Continuous Bond Disclosures as well as the process for making the disclosure. Mr. Sundstrom made a modification substitute motion to bring this issue back and look at the subsequent disclosures for the next AOC meeting.  
Substitute Motion VOTE: Mr. Moorlach moved the item, Second – Carlson, Yes-Sundstrom, Yes-Mauk, Excused-Bates

Dr. Hughes stated he raised concerns regarding the adequacy of the disclosure related to the SIVs in the CAFR that was issued on December 12, 2007. He stated the County was completely silent regarding the County's holdings of SIVs in its 2007 CAFR. Dr. Hughes stated he brought his concern to the A-C, MGO, and CFO on February 27, 2008. Dr. Hughes stated he told the group that he believed some type of disclosure would have been appropriate. This was due to the fact that the County held almost \$1 billion in SIV or 16% of its investment pool at a time when SIVs in the industry was defaulting due to the collapse of their supporting assets. Dr. Hughes' main concern was whether or not the AICPA and SEC standards required the County to make a disclosure. Upon a very in-depth analysis of the audit standards, he agreed with the A-C and MGO that the standards did not require a disclosure, but did not prevent disclosure if management was so inclined.

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Mr. Sundstrom stated he did an exhaustive review of pertinent auditing standards AU560 and AU561 dealing with subsequent events and AU530 dealing with the dating of an auditor's report. Mr. Sundstrom stated the matter was discussed extensively internally and with the auditor (MGO) prior to release of the financial statements on December 12<sup>th</sup>, 2007. Mr. Sundstrom explained the dating of the reports. The first date was the actual date of the auditor's report, December 12, 2007. The second date was the date the auditor (MGO) gave the client (A-C) the report, December 20, 2007.

The third date was when the reports were published, January 12, 2008, meaning the reports were returned from printing and then distribution was made. As of the 12<sup>th</sup> of January, it was the A-C's opinion that there was nothing material that required disclosure in the financial statements based on his review of AU560 and AU561 as it related to a subsequent event that would either require a Type 1 or Type 2 disclosure in the financial statements.

Mr. Sundstrom stated the SIVs in question were on credit watch negative at that particular time, but no rating agency had downgraded those investments. Mr. Sundstrom said the Treasurer had devalued or slightly written them down at that time. He said that work was reviewed and in his view it was an overly conservative write down and at that time, even though it was several million dollars, it was not material enough to the financial statements as a whole. Additionally, he felt it was a normal course of a 6 billion dollar investment portfolio. Accordingly, the A-C did not pull the financial statement from the printers. He said it was not enough on December 10, 2007 to write a separate disclosure so he released the statements without changes. Mr. Sundstrom said that subsequently Dr. Hughes reviewed the issue and felt there might be a need to disclose the SIV matter in the financials and raised the question as to whether or not a recall and reissue of the financial statements was required. Mr. Sundstrom did not see any additional information to change his original position and accordingly did not recall and reissue the financial statements. Mr. Sundstrom asked Mr. Godsey of MGO to address the Committee.

Mr. Godsey addressed the Committee. He stated they had an on-going responsibility with the audit that if anything came to their attention about the audit, they would evaluate what impact it would make on their opinion. In consultation with their in-house experts in the field, they sought their insights. He stated that just prior to December 20, 2007 there was great discussion just before the release of their opinion. Mr. Godsey said they were aware that the Treasurer made a report to the Board of Supervisors about the deteriorating status of the SIV fair market value. His concern was first that there may be any change of value which would result as a Type 1 disclosure given its materiality to the financial statements taken as a whole. Being that it was not the case, the need for subsequent or additional disclosures of anything that happened after the balance sheet date but before the release of the report was then considered. They evaluated the rating agency information and met with the Auditor-Controller. Mr. Godsey stated the Auditor-Controller did not feel a need for disclosure and consequent recall of the financial statements. Their internal experts concurred that there was not a material exception to the disclosures that would impact their opinion.

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MGO continued to monitor the market and dynamics of change. The PFM report was released at the end of January 2008. Mr. Godsey stated an event after the opinion and release date of the financials, although significant, did not obligate MGO to inform the users of those financial statements that they could no longer rely upon their opinion. However, had the PFM identified a material event that had taken place prior to December 20<sup>th</sup> MGO may have considered a different course. The PFM report triggered another follow-up meeting with Auditor-Controller and Treasurer. Mr. Godsey stated that IAD shared their concern and the information was gathered. The conclusion was formed that there was not a material event that would require MGO to withdraw their opinion on the financial statements unless reissued. The meeting on February 24, 2008 with The Director of Internal Audit, the Auditor-Controller, and Macias, Gini, & O'Connell confirmed their understanding and the consensus was that there was no obligation to recall the financial statements.

Mr. Godsey said the on-going concern of disclosures at that point was that the County did have, on some of its outstanding bonds, continuing disclosure requirements. He said developments in the SIV condition would be heavily considered as part of any on-going bond disclosures.

Dr. Hughes stated the County had an opportunity with the annual Treasury Fund Audit being conducted by the Auditor-Controller, to make a disclosure in the next few months to enable the County to make a contemporaneous disclosure rather than waiting a year for the next CAFR. Dr. Hughes stated a Continuous Bond Disclosure went out last week. He said that Mr. Franz offered to submit an updated PFM report as a supplement to the bond disclosure. He added that Mr. Franz was evaluating a web-based clearinghouse communication with the investment community to allow for just-in-time information. Dr. Hughes restated he agreed with A-C and MGO that a recall and reissue was not required at this time. There were other vehicles to keep the investment community informed than the 2007 CAFR.

Mr. Mauk stated he never felt the financial statements would need to be reissued as regards to the SIVs. He was comfortable with what MGO presented. However, he was not comfortable with the filing of the PFM report as a disclosure document because it had not disclosed the current status. He said the PFM report stated that the Whistlejacket SIV was a fine investment when at this time it defaulted. Mr. Mauk asked specifically what the Auditor-Controller and Treasurer were going to do to be sure that the investment community was aware of the current status of the investment portfolio of the OC as it evolved and changed. Mr. Mauk felt comfort that the Auditor-Controller's upcoming annual audit of the Treasurer's investment pool would make a disclosure to bring the County current. Mr. Sundstrom stated he spoke with Mr. Gorman from the Treasurer's office that morning and said they were in the process of drafting the footnotes to the financial statement that would address the SIVs condition. Mr. Mauk stated his interest was to have a level of comfort that the Board was protected as respects to the current situation of the County's investment portfolio as opposed to the important but resolved question that it was not necessary for the County's financial statement to be revised. He requested to know what steps would be taken for on-going proper disclosure and for the specific disclosures made or proposed be brought to the AOC for review and approval.

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Mr. Franz said relating to continuing disclosure, there were five points during the year as related to disclosure. He stated one was made last week that had the standard information that it was required to put into their financial statements. Also, filing the PFM report was not adequate because things had happened since the report was issued. They are now working with PFM to have them update the report to describe the changes since January 29, 2008. The intent would be to file that as the amendment on continuing disclosures. As other reports were issued they would be considering those for release as well. Mr. Franz stated the bond buyers and bond holders would be the recipients of the reports. The continuing disclosure requirements on the investment portfolio activities did not technically require him to amend the disclosure or even disclose the activities. Yet in the abundance of caution, they worked with outside disclosure counsel and it was concluded that an amendment and a description would be filed electronically.

Mr. Gorman stated that Tustin Unified School District was in the process of issuing their general obligation bond and spoke with their counsel about the need to expand on their disclosure and that they were working with their counsel and Auditor-Controller on this issue. Mr. Moorlach requested Mr. Franz to provide copies of the SEC report to the Board of Supervisors on a regular basis.

Mr. Moorlach asked Mr. Gorman when the write-down was reflected on the SIVs. Mr. Gorman responded, November 30<sup>th</sup>. Mr. Moorlach asked if those numbers were included in the June 30, 2007 numbers or if a GASB 31 adjustment for the SIVs was done. Mr. Sundstrom stated it was not required. Mr. Godsey stated that had there been an impact on the June 30, 2007 balances as a subsequent event it would have triggered the need to go back and change the financial statements, but that was not the case. It was an event subsequent to that. Mr. Godsey stated the only option they considered was the need for a disclosure as a subsequent event. The need to write down for June 30, 2007 was not there. Mr. Godsey stated that if Management had elected to recall the financial statements to include the disclosure normally they would reissue their report with dual dates. For example, they would issue their report with an issue date of December 4<sup>th</sup> with the exception of paragraph 3, note 18 on subsequent events where the disclosure would be made. Mr. Moorlach stated the whole SIV issue was very public and asked MGO if there was a discussion to include a small footnote or just a mention of the SIV situations in the disclosure versus a full blown one and why they decided to do nothing at all. Mr. Godsey stated his role was not to be an arbitrator on the issue. They were to understand the facts and either agree or disagree with Management once Management reached a conclusion. At the time MGO issued their opinion, it was management's call and had there been a sense that the lack of disclosure was material or material misstatement in the financial statement, MGO would have absolutely come forward and would have said they would not be able to issue their opinion. MGO concluded that the lack of the disclosure by Management would NOT require them to change their opinion.

Dr. Hughes noted that they explored what was mandatory and required for disclosure versus what was optional. The authoritative text left it up to professional judgment of the

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individual entity. There were no fixed numbers or magical thresholds that would automatically require a disclosure. The guidance provided was to advise the entity, in light of the circumstances; to determine what they felt would influence the investor. Therefore if Management had decided to make a disclosure there was nothing to preclude it nor was there any stated definitive event ratio or number that obligated a disclosure. Mr. Moorlach stated that in 2002 after Edison had defaulted on some its notes, Orange County chose to disclose. He felt that if the County erred, we should err on the side of too much rather than too little in our disclosures.

Dr. Hughes stated that Internal Audit was proposing to audit CAFR and on-going Bond disclosure process with an eye to making it more formal.

Mr. Sundstrom stated there was extensive discussion on the disclosure issue all around. Mr. Sundstrom offered to Dr. Hughes that if he wanted to be brought to the table in the future on the CAFR disclosures then certainly, Mr. Sundstrom would include him in future conversations. Mr. Sundstrom wanted to be consistent with prior financial statements. It should be noted that while a few SIVs were on credit watch none had been down graded as was the case with Edison securities in 2002. California Edison dropped down to a D rating that caused a lowering in the value of the whole investment pool itself. He personally conducted a considerable amount of research to conclude the SIVs were not in danger. He was convinced that there was nothing in peril at the time of the release of the financial statements. PFM came to the same conclusion and he was relieved and happy with the conclusions of the report.

Mr. Moorlach requested that the minutes reflect the extensive dialogue that the key officers of the County discussed this matter in depth.

Mr. Sundstrom asked Dr. Hughes who told or authorized the assignment. Dr. Hughes stated that as the Director of Internal Audit, he is chartered with making ongoing assessment of risk and bringing them to Management's attention. He is not limited to identifying risk in a calendar year and then playing deaf, dumb and blind simply because the issue was not scheduled for an audit. As issues presented themselves, IAD evaluates the risk and bring it to management, the Board and the AOC's attention as warranted. Mr. Sundstrom stated that in the future, as AOC Chair, he wants to be informed of any self assigned audit work as soon as possible. Dr. Hughes stated that he would bring such issues to the attention of the AOC. Dr. Hughes stated he still wanted to get preliminary information together before it was elevated it in order to have a basis for discussion. Dr. Hughes stated that in the future he could bring it to the attention of the Chair. Mr. Mauk felt Mr. Sundstrom should have been included sooner because of his position as the Auditor-Controller and as the issuer of the financial statements, as well as his role as Committee Chair.

Mr. Moorlach felt when Dr. Hughes brought it to his attention as the Chair of the Board he felt it was a manager doing his job. The points raised by Dr. Hughes were valid and should have been raised. Mr. Moorlach stated that the issue of protocol would be worked out in the future.

9. Discuss the update on the selection of an External Auditor  
VOTE: Motion-Mauk, Second-Moorlach, Yes-Sundstrom, Yes-Carlson, Excused-Bates

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**Received.**

Mr. Sundstrom stated the subcommittee met and reviewed 4 evaluations. An ASR was being prepared for Board consideration.

10. Approve 2008 Audit Oversight Committee Meeting Schedule  
VOTE: Motion-Moorlach, Second-Mauk, Yes-Sundstrom, Yes-Carlson, Excused Bates  
**Approved.**

The approved 2008 dates were as follows: May 29, 2008, 2pm; August 21, 2008, 2pm; November 13, 2008, 2pm. The next meeting will be held at 333 W. Santa Ana Blvd., Building 10, 5<sup>th</sup> Floor, Conference Room B.

11. Election of Officers – Nominate and Elect 2008 Chair and Vice-Chair for the Audit Oversight Committee  
Motioned Mr. Sundstrom was nominated as Chairman, Seconded by Mr. Mauk.  
Motioned Dr. Carlson was nominated as Vice-Chairman, Seconded by Mr. Sundstrom.  
VOTE: Moved-Moorlach, Seconded-Sundstrom, Yes-Mauk, Yes-Carlson, Excused-Bates

**Public Comments** – none

### **AOC COMMENTS & ADJOURNMENT:**

AOC COMMENTS: none

ADJOURNED: 12:30 p.m.

### **NEXT MEETING:**

May 29, 2008                      Regular Meeting,                      2:00 p.m.