

Summary Minutes Audit Oversight Committee

REGULAR MEETING OF THE AUDIT OVERSIGHT COMMITTEE
ORANGE COUNTY, CALIFORNIA



Thursday, May 29, 2008, 2:00 p.m.

HALL OF ADMINISTRATION
333 Santa Ana Blvd, 5th Floor
Conference Room B
Santa Ana, California

TELECONFERENCE LOCATION: IHS, Inc.
10955 Westmoor Drive, Suite 335
Westminster, Colorado 80015

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, Chriss Street, Dr. David Carlson,
Bob Franz (Proxy for Tom Mauk)

EXCUSED: Patricia Bates, Thomas Mauk

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

2:05 P.M.

1. Roll Call
Guests: Internal Audit Staff: Eli Littner, Alan Marcum, Autumn McKinney, Michael Goodwin, Ken Wong; Auditor-Controller Staff: Shaun Skelly, Claire Moynihan, Toni Smart, James Christiansen, Christine Young; County Executive Office Staff: CFO Bob Franz, Tom Beckett, Faye Watanabe, Colin Hoffmaster, Laurie Sachar; Treasurer Tax Collector Staff: Paul Gorman; Vavrinek, Trine, Day & Co., LLP: Kevin Pulliam; Third District staff: Matt Petteruto, Louis Bronstein; Second District Staff: April Rudge; Office of the Performance Audit Director: Steve Danley, Ian Rudge
2. Approve Audit Oversight Committee Minutes of February 28, 2008
VOTE: Moved-Franz (Proxy for Mauk), Seconded-Moorlach, Yes-Sundstrom, Abstain-Carlson, Excused-Bates
Mr. Sundstrom handed out recommended changes of the AOC minutes for approval.
Approved with presented changes from Mr. Sundstrom.

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3. Approve Audit Oversight Committee Minutes of April 7, 2008
VOTE: Moved-Moorlach, Seconded-Franz (Proxy for Mauk), Yes-Sundstrom, Yes-Carlson, Excused-Bates
Correct minutes to reflect the absence of Dr. Carlson.
Approved as recommended with correction.

4. Approve OC Internal Audit Department FY 2008-2009 Audit Plan and Risk Assessment
VOTE: Moved-Moorlach, Seconded-Sundstrom, Yes-Carlson, Yes-Franz (Proxy for Mauk), Excused-Bates
Approved as recommended.

Dr. Hughes addressed the AOC and explained the detail of the risk assessment and the development of the audit plan. Scope and objective were provided for the coverage proposed. He stated materiality was the driving force based on risk. Input was sought and received from mostly all of the departments as well as the Board members. There could be competing demands for resources and time.

Mr. Moorlach asked about item 6, page 3, ATS specifically. Ms. McKinney explained the County policy required agencies to notify Internal Audit of any financial systems that were being developed. Internal Audit was working with the Assessor's office on the issue. Assistance was offered by Internal Audit for a review of the controls for the system implementation. The Assessor's notification to Internal Audit was that he did not feel the system implementation was a financial system and therefore did not request assistance from Internal Audit on the ATS system implementation. Internal Audit also issued an Audit Alert recommending the Assessor obtain the consulting services of an IV&V expert on the project for risk mitigation. The Assessor responded that quality assurance was already built into the project. Mr. Franz stated they had discussions with the CIO to include the ATS status into the quarterly IT presentations. Mr. Moorlach stated the Board was requesting quarterly reports from the Assessor and requested some questions to be drafted by Internal Audit to assist him in regards addressing the IV&V factor.

Dr. Hughes said the budgeted hours for the proposed audits were estimates. More or less time could be needed based on the audit progress and those changes would be reflected in the quarterly status reports. Historically speaking, the audits were done within the hours estimated. Dr. Hughes stated the approach was based on the more global issues with County-wide impact. Dr. Hughes suggested that CSA cycle back to assist with the recent reorganizations. Mr. Sundstrom offered to speak with Steve Franks, the new OC Community Resources Director regarding CSA.

Members complimented Dr. Hughes on the process and stated the audit plan was ambitious and well constructed as presented and did justice to county risks.

Mr. Sundstrom commented on item 10, page 6, the auditing and accounting standards update. He stated the external auditor was present in the room. He felt the Statement of Auditing Standards (SAS) 103 through 111 would cause heartburn. He said he was seeking a contract with an external auditor that had experience in documenting control processes. The contractor would put it together, give him the framework and teach him how to fish.

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They would put all the control structures together in a fashion that would be usable by the external auditor in their opinion on his financial statements. Mr. Sundstrom may ask Internal Audit for assistance. Dr. Hughes explained the AICPA had new auditing standards that required the external auditors to do a more rigorous review of internal controls than in the past. The new standards required better documentation of those controls on behalf of the client. Indirectly, the AICPA was driving management to take more responsibility for establishing and maintaining adequate internal controls for the financial statements. Mr. Sundstrom stated the next CAFR would be conducted under those standards. Dr. Hughes offered to assist if asked.

5. Discuss Continuous Bond Disclosures regarding the SIVs Held in the County's Investment Pool and direct staff (AOC 2/28/08, Items 6 and 8)
Received. This item required no action.

Mr. Tom Beckett, Public Finance Manager, addressed the AOC concerning bond disclosure in the County investment pool structured investment vehicles. Mr. Beckett provided an overview of disclosure requirements and gave background into Orange County. He stated disclosure, in general, Orange County was a highly sensitive subject primarily due to the County bankruptcy. In the course of working through the bankruptcy with the IRS and SEC, a significant amount of analysis was done on what went wrong. Most of what came out was focused on the shortcomings. We received major criticism over failure to disclose level of risk in the investment portfolio and failure to disclose illiquidity in the investment portfolio. Mr. Beckett stated the question for disclosure in financing new bonds was, were you telling everything that an investor would want to know? And secondly, were you telling the story in a way that was not misleading? Along with every financial report were the continuing disclosures that updated the official statement to the investment community.

Mr. Beckett stated they pondered many questions concerning adding a disclosure related to the SIV's earlier in the year. It was not a reportable event based on the list. They conferred with disclosure counsel and asked if it was something they were obligated to disclose. The conclusion was the County was not obligated to disclose it, but they would not be faulted for over disclosure. The County had recently received the report on PFM asset management on the risk analysis of the investment pool and it was discussed. It was agreed to file the PFM report, including their update, with the NRMSIRs (Nationally Recognized Municipal Securities Information Repositories). The difficulty with the SIV issue was that it was developing day by day.

Public Comments –

Mr. Sundstrom moved Public Comments forward to address the 12/31/07 audit of the investment pool. Mr. Gorman of the Treasurer's office discussed the draft financial statement. He stated he worked with Toni Smart of the Auditor-Controller's Internal Audit Function and she reviewed the draft financial statement and returned it with comments. He stated he had not completed those comments nor had she had a chance to review the changes the Treasurer's office made to it. The disclosures were similar to what was presented in the CAFR. On page 7, the disclosure detailed subsequent events and the Structured Investment Vehicle holdings were shown.

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The Orange County taxable pension obligations bonds was a standard disclosure that was in the CAFR for the last few years. He disclosed asset backed commercial paper and SIVs as a group. Mr. Gorman stated they had holdings in both areas. A brief description of the credit heightening from last year was provided. He stated they collected all the asset backed commercial paper that was on the balance sheet as of December 31, 2007 and it was disclosed. It was collected and there were no concerns about those.

For the SIVs, he stated they tried to provide a disclosure that described the current standing of those assets to date. It seemed it changed every day. He said they tried to disclose higher level of holdings in each issuer and the fair value at an issuer level for the relationship between the County pool and the educational pool as well as the one holding in specific investments. Mr. Gorman stated they disclosed current credit ratings of each of the SIVs and prepared a status of each SIV as of May 29, 2008. He said the PFM also said that the Treasurer needed to continue monitoring Sigma and Whistle Jacket. Mr. Gorman said the remaining disclosure was on Whistle Jacket due to its credit down grade and Default. Included was an update on Sigma finance. Mr. Gorman stated the A-C/Internal Audit Function suggested a reformat change into a narrative form for the subsequent events related to Whistle Jacket.

Mr. Gorman stated Whistle Jacket was the most difficult and they took the issue up through the High Court of Appeal. Their court decision was last week and Mr. Gorman stated they may be able to update that further if there was no appeal in the next week or so. Anyone from Great Britain or through the High Court of Appeal had until June 5, 2008 to file information on an appeal.

Mr. Moirlach suggested an explanation of the asterisks on Note 2 of the footnote because the prior page used asterisks and it signified John Wayne Airport. Mr. Gorman said it was on credit watch negative and Mr. Moirlach suggested using CWN. Mr. Moirlach asked if the subsequent events on the disclosure for Whistle Jacket stated they had paid their interest. Mr. Gorman said the disclosure stated they were in Default in a few different places. Mr. Moirlach asked if Sigma was performing as expected. Mr. Gorman stated Sigma had a brief disclosure and they were in discussions about possible asset swaps. Mr. Gorman said full disclosure was important and how much to put in is really the question without providing too much information. He stated their goal was that anyone reading the financial statements would be clear about their holdings and notes in those structure investment vehicles (SIVs).

Mr. Sundstrom stated the Auditor-Controller/Internal Audit Function had not had a chance to thoroughly review the disclosure with the changes that Mr. Gorman presented, but they had several comments on the prior version.

Mr. Sundstrom introduced Ms. Toni Smart, Audit Manager, CPA, formally from the OC BOS Internal Audit Department to provide an update on the treasury funds audit ending 12/31/07. He stated there were some delays in issuing the report because of the uncertainty of Whistle Jacket. Ms. Smart stated she received the notes from the Treasurer's office on May 16, 2008. The revisions as presented at the meeting had not been reviewed yet and they needed time to go through and thoroughly audit those notes. She said they need to confirm that everything was properly restated and hoped to issue an audit report in approximately two weeks.

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Ms. Smart stated their current position was that she planned to qualify their audit opinion. The qualification pertained to the Whistle Jacket fair market value. The Treasury used an evaluation methodology that Ms. Smart was unable to obtain adequate support documentation to conclude what was an appropriate fair market value so, in lieu of that, the decision was to issue a qualified opinion. She stated everything else was fairly stated, but she had not had an opinion regarding the fair market value of Whistle Jacket.

Mr. Moorlach asked what it would take to get the right documentation. Mr. Sundstrom responded, it would take the Treasurer to sign a confidentiality agreement to determine the value of the underlying assets and the county's share of those assets. Mr. Moorlach stated if they were using professional services to determine the value of investment why Bloomberg or someone else wasn't used. Mr. Gorman responded that Bloomberg stopped pricing as of February 22, 2008. Ms. Smart stated the requirement was that if an event occurred prior to the balance sheet date, in this case 12/31/07, the SIV situation needed to be addressed. The fact is these specific SIVs were in distress. Therefore it required that the balance sheet be adjusted for fair market value based on subsequent events. And that situation with a footnote disclosure which differed from what happened with the CAFR where the events were not in place at the time of the June 30, 2007 date and as such did not require disclosure in their professional judgment. For that reason the fair market value adjustment was now necessary according to auditing standards.

Mr. Moorlach asked if 86% value was an appropriate value. Ms. Smart responded, she could not make any determination on that if that was indeed an appropriate value. It was because the valuation methodology the Treasurer's office used she could not obtain enough evidence to support that was the proper value. She stated it was her suggestion that they obtain a couple of bid prices. There was a bid price that was reviewed at 72 cents on the dollar dated April 18, 2008. The difference between the 72 and 86 cents was a material amount to the financial statement. The difference was about 12 million dollars.

Mr. Gorman responded as to why the Treasurer's office didn't devalue its SIVs to the 72 cents on the dollar and avoid a qualified opinion. Mr. Gorman stated they had two notes, the current scheduled interest payments on those notes and they know the interest rates. The guessing part was they had to say the underlying portfolio for Whistle Jacket was an average weighted maturity at three and a half years. He said they looked at what a double B rated asset with maturity of three and a half years would be. Although it was rated B, there wasn't a yield curve for that so they were forced to use the double B.

Mr. Gorman said they came out with a discount rate from what a double B security would be priced at roughly 2 percent off of what they were earning and the discounted the cash flows. Assuming quarterly payments for three and a half years which was a guess, they were operating at a high level. Mr. Gorman said he didn't know what the underlying assets would pay and they wouldn't know what payment would be made.

Mr. Moorlach asked if all upcoming quarterly reviews to be conducted by Mr. Sundstrom would be qualified. Mr. Sundstrom stated Opinions were not stated on quarterly cash counts, but the annual audit the County Comprehensive Annual Financial Report (CAFR) in June was then the responsibility of the external auditor.

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He said the AOC will have all the way until December to discuss the valuation of the SIVs and related footnote disclosures in the CAFR. Mr. Sundstrom said it was the Treasurer's view that these conditions would change. Mr. Sundstrom said one thing likely to occur was that a cash payment would be made before then. He said they're going to make a distribution of cash and if it lowered the holding value down by possibly 16 or 17 percent that it may drop below the level of the materiality threshold as established by the external auditor for the CAFR.

After the court proceedings, Mr. Franz stated we would be back talking about signing a confidentiality agreement and what the issues were there. Mr. Street responded that if there was no appeal delivered to the House of Lords by June 5, 2008, it was the indication of the receiver that he would move forward on a restructure rapidly and that there was a probability of a distribution in the near term. If there was an appeal, it could be a delay of up to six months. Mr. Street said if there was a restructure, you get a very extreme level of disclosure. For this particular exercise, the information presented bi-monthly did not suffice to come up with a valuation even though there was an indication of valuation.

Mr. Sundstrom stated it was important to note, for CAFR purposes, what the effect would be on the county of a qualified CAFR statement should the Treasurer not be able to defend the fair market value of the SIVs to the external auditor's satisfaction. If the issue wasn't resolved by the CAFR issuance, as the County Auditor he would make a strong recommendation to the AOC and Treasurer for a write down to the bid price at that time to enable an unqualified opinion. He didn't feel an unqualified opinion going to Wall Street was what the County should do. Mr. Street felt FASB 157 was inappropriate. Ms. Smart stated FASB 157 was a new pronouncement on fair market value measurements. Mr. Moorlach stated by June 2008, we would have to come up with something out of FASB 157 to resolve the issue. Mr. Sundstrom stated Ms. Toni Smart's signature, as his independent auditor, was on the audit report and it was her best advice and professional judgment to qualify the auditors opinion in her report.

AOC members agreed that this discussion was very helpful and looked forward to further AOC updates and discussions regarding the proposed SIV disclosure in the next CAFR.

No other public comments were received.

6. Receive and file OC Internal Audit Department Status Report for period January 1, 2008 through March 31, 2008 and Executive Summaries of Audit Finding Summaries for the Period January 1, 2008 through March 31, 2008
VOTE: Moved-Moorlach, Seconded-Franz (Proxy for Mauk), Yes-Sundstrom, Yes-Carlson, Excused-Bates
Approved as recommended.

7. Receive and file External Audit Coverage 2nd Quarter Status Report FY 07/08
VOTE: Moved-Moorlach, Seconded-Franz (Proxy for Mauk), Yes-Sundstrom, Yes-Carlson, Excused-Bates
Approved as recommended.

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AOC COMMENTS & ADJOURNMENT:

AOC COMMENTS: none

ADJOURNED: 3:30 p.m.

NEXT MEETING:

September 17, 2008 Regular Meeting, 2:00 p.m.