

S U M M A R Y M I N U T E S

REGULAR MEETING OF THE AUDIT OVERSIGHT COMMITTEE
ORANGE COUNTY, CALIFORNIA



Wednesday, December 4, 2013, 2:00 p.m.

HALL OF ADMINISTRATION
333 Santa Ana Blvd., 5th Floor
Conference Room A
Santa Ana, California 92701

Supervisor Shawn Nelson
Chairman

Dr. David Carlson, CPA, Public Member
Vice-Chairman

Supervisor Pat Bates
Member

Jan Grimes, CPA
Auditor-Controller
Member

Michael Giancola
County Executive Officer
Member

Shari L. Freidenrich, CPA
Treasurer-Tax Collector
Member

Philip Cheng
Performance Audit Director

Sarah J. "Sally" Anderson, CPA
Public Member

Bruce Hughes, CPA
Public Member

Mark Wille, CPA
Public Member

ATTENDANCE: Shawn Nelson, Jan Grimes, Michael Giancola, Philip Cheng, Don Hughes as Proxy for Pat Bates, Gary Caporicci as Proxy for Mark Wille

EXCUSED: none

ABSENT: Shari Freidenrich, Sally Anderson, Bruce Hughes

PRESENT: Director of Internal Audit: Dr. Peter Hughes, CPA
County Counsel: Ann Fletcher
Clerk: Renee Aragon

2:00 P.M.

1. Roll Call

Attendance of AOC members is noted above.

Internal Audit staff – Mike Goodwin, Alan Marcum, Michael Dean, Dave Wiggins; Auditor-Controller Staff – Denise Steckler, Victoria Ross, Autumn McKinney, Toni Smart, Tonya Burnett, Nancy Ishida; OC Public Works staff – Howard Thomas and James Tyler; External Auditors Macias, Gini, O'Connell – Jim Godsey, Linda Hurley and Katherine Lai

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2. **Approve Audit Oversight Committee regular meeting minutes of September 4, 2013**
Motion-Carlson, Second-Giancola, Yes-Nelson, Yes-Grimes, Yes-Cheng; Yes-D. Hughes (Proxy for Bates), Yes-Caporicci (Proxy for Wille), Absent-Freidenrich, Absent-Anderson, Absent-B. Hughes.

Approved as Recommended with correction to page two, item three, first paragraph, fourth sentence to read: "...Generally Accepted Accounting Principles."

3. **Receive Verbal Status Update from External Auditors regarding the audit of the FY 12-13 Comprehensive Annual Financial Report (CAFR)**
Verbal Status Received and Filed as Recommended.

Macias, Gini & O'Connell (MGO) Partners introduced themselves. Linda Hurley, Engagement Partner, Katherine Lai, Partner on Component Units of the Single Audit Report, and Jim Godsey, Client Partner.

Ms. Hurley discussed three areas: 1) audit status, 2) summary of current year matters and 3) potential finding and management letter comments being considered as part of the audit process.

Ms. Hurley stated the current audit status was that fieldwork was almost complete. They expect to receive a complete draft of the CAFR on December 5, 2013 for their technical review process which would take approximately two weeks. She stated they would meet with Executive Management on Monday, December 9, 2013 as part of the CAFR review process to discuss the audit issues identified and the new Accounting Standards the County was issuing. She stated MGO would provide comments by December 18, 2013 and the revised target issuance date would be January 10, 2014.

Ms. Hurley said an item highlighted in the previous AOC meeting on September 23, 2013 regarding the reporting of CalOptima financial information would be included in the CAFR as a restatement and also would be a footnote disclosure in the financial statements.

Ms. Hurley stated they identified several audit adjustments. Some of those adjustments were from prior year restatements of an equity position. The first area related to capital assets. The second area was revenue and expense accrual related to Health Care Agency (HCA). The last adjustment was related to long term debt and the capital appreciation bonds. As part of Single Audit procedures they examined the capture of federal expenditures on the Schedule of Expenditures of Federal Awards (SEFA). She stated the medical assistance program was identified as not properly capturing their expenditures year to year. Ms. Hurley stated they were working with that department to capture previous year's expenditures that should have been reported as part of their program. This was being included as part of the scope of their audit.

Ms. Hurley stated they were also evaluating the Section 8 program that potentially has expenditures in previous years that were not captured on the SEFA.

Ms. Hurley said another matter raised was compliance with debt covenant. She stated the County had not filed their required continuing disclosure statements related to 1996a and 1997a pension bonds. They identified that those statements had not been filed for the last five years from 2008 through 2013. Ms. Hurley stated they understood the County was brought current with those filings but the matter would be considered material non-compliance and reported according to government auditing standards.

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Ms. Hurley stated for the area of potential finding and Management Letter comments there were potentially three material weaknesses in internal control related to capital assets. She stated the areas were the preparation of the County's SEFA and compliance with debt covenant. She stated the types of issues raised were indicative of a material weakness in internal controls. Ms. Hurley emphasized they were still evaluating issues and had not formally drafted any comments. She stated they had discussed the matters with management. She stated they would be finalizing the issues during the technical review process of the overall CAFR and then would determine how the issues would be reported.

Ms. Hurley stated two significant deficiencies in internal controls were identified in subsequent event review of accruals through report issuance related to the HCA item above as well as accounting for long term debt surrounding the capital appreciation bonds also noted above as an audit adjustment.

Mr. Jim Godsey referenced the potential adjustments as they related to material status and said the County had an option. He stated that if MGO identified an adjustment that was below materiality levels, it would not impact MGO's decision or opinion on the financial statement if it was a past adjustment. He said historically that County management had taken the position on the relatively small items and there were no past audit adjustment. Ms. Hurley confirmed the areas being considered for adjustments. Mr. Godsey said that if the matters end up being finalized as needing correction, County management would have some options. Ms. Hurley also noted that a material weakness in internal control could be triggered by their evaluation of the process and whether or not there was a likelihood that a material misstatement could occur. If there was a material adjustment identified, it was likely a material weakness would also be noted.

Mr. Godsey stated the County had received a certificate of excellence in reporting from GFOA because of timely submission by December 31st of each year. The program allowed for a 30 or 60 day extension and he understood that Orange County had requested an extension.

Dr. Dave Carlson, Vice-Chairman, stated the phrase "material non-compliance" raised concern in any audit activity. He asked MGO to speak to the form and impact of communicating that judgment. Ms. Hurley said auditing standards required evaluation of internal controls and compliance related to financial non-reporting. She said in the area of debt covenant they evaluate if proper reserves existed, proper disclosures were made, and the filing of financial information was made related to debt as part of the material compliance requirement. She again noted that full evaluation was not completed but discussions with management and the AOC were required. Mr. Godsey stated they would provide an opinion on the financial statements, a report on internal controls and compliance at the entity level, and a report on internal controls in compliance over the single audit programs with federal financial assistance. He stated they would examine the significance of the material non-compliance and what was the financial exposure to the County for not filing.

Dr. Carlson asked Mr. Godsey what the vehicle was for the root cause of non-compliance. Mr. Godsey stated the standards suggest that if we identify something and the cause, it should be reported. However, it was not required under the basic governmental audit standards to do additional work and go back and necessarily understand the root cause. He said they know it wasn't reported and not sure how it was missed. Ms. Hurley said as part of final write up there was a section that would state the cause and effect of the finding and they would be put into context based on their understanding of the issue at that level.

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Mr. Gary Caporicci (Proxy for Mr. Wille) asked to clarify the restatement of CalOptima. Ms. Hurley stated the restatement was under GASB 14. Mr. Caporicci asked if GASB 16 relieved them. Ms. Hurley stated the reason it was being drawn into the financial statements was because GASB 16 had no impact on that section of GASB 14. Mr. Caporicci asked how long it should have been reported. Ms. Hurley said since the early 1990's. She noted that CalOptima was incorporated about the same time GASB 14 was implemented. She stated there were a number of health plans throughout the state and various counties had the health plans. Orange County was not the only county with this restatement and she stated it was identified as part of the County's due diligence through the GASB 16 evaluation. Mr. Caporicci asked what the prior auditors said. Ms. Jan Grimes, Auditor-Controller, said the prior auditors had not been contacted yet.

Mr. Caporicci asked for clarification of the three material weaknesses. Ms. Hurley stated identified areas were the preparation of the schedule of expenditures of federal awards, capital assets, and compliance with debt covenant. She stated the accrual and long-term debt was evaluated as significant deficiencies. Mr. Caporicci asked what the effect was of those material weaknesses identified on the opinion. Ms. Hurley stated none. Supervisor Nelson asked when the final report was to be released if it would reflect that the County was not in dispute of the finding and remedy was started. Ms. Hurley said that as part of the finding, they would state the criteria, the condition, the cause and effect and their recommendation. The County would provide a written response and it would be included in the report.

Supervisor Nelson, Chairman, asked if the Auditor-Controller Ms. Grimes or anyone else would have reason to disagree, at least preliminarily, with any findings. Ms. Grimes said not at this time.

Dr. Carlson stated it was not filed since 1998 and was concerned. Ms. Hurley corrected that date and said had been five years since 2008 for the debt covenant (pension issue). Mr. Godsey said there was a possibility that there could be a difference of opinion between MGO and management on a finding. He said they would work very hard and if there was no disagreement with factual content, they would work to be in agreement with management as to what the condition was. As far as their opinion vs. management opinion on what the recommendation would be, perspectives may be different.

4. **Receive and file the Annual OC Fraud Hotline Activity Report for the Period July 1, 2012 to June 30, 2013)**

Item Received and Filed as Recommended

Dr. Hughes stated that having the OC Fraud Hotline administered by Internal Audit was a best practice in the industry. Furthermore, he stated the following components of the Hotline were also best practices: IAD provided 24/7 service and offered both on-line and phone access and it released to the public "finding results" at least annually while still maintaining legislatively required confidentiality. Dr. Hughes introduced Mr. Dave Wiggins, Esq., as the new Fraud Hotline Manager. He had been in position for almost a year. He was hired as the OC EEO officer by Human Resource Services prior to joining the Internal Audit Department. Mr. Wiggins addressed the AOC. He stated he practiced law for over 25 years prior to joining the County.

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Dr. Hughes stated the report identified trends over the past three years. He stated the hotlines had increase by almost 20 percent. He said the OC Fraud Hotline was promoted in various ways in order to encourage its use.

Dr. Hughes stated the AOC Subcommittee on Fraud and Ethics would be looking at a possible name change. He assembled material related to other large cities and counties in California to help the subcommittee pick a name. He said the most common title is Fraud Hotline. Dr. Hughes stated any suggested name change would be presented to the AOC and then the Board of Supervisors for consideration and approval.

Dr. Carlson stated the Subcommittee would meet on December 23, 2013.

5. **Approve OC Internal Audit Department FY13-14 1st Quarter Status Report for the period July 1, 2013 through September 30, 2013 and approve 1st Quarter Executive Summary of Audit Finding Summaries for the period July 1, 2013 through September 30, 2013**

Motion: Giancola; Second: Carlson, Yes-Nelson, Yes-Grimes, Yes-Cheng; Yes-D. Hughes (Proxy for Bates), Yes-Caporicci (Proxy for Wille), Absent-Freidenrich, Absent-Anderson, Absent-B. Hughes.

Approved as Recommended

Dr. Hughes stated the audit plan was a collective effort that involved input from all departments and the Board offices. All changes, revisions, or deletions were disclosed and reflected in the notes and presented to the AOC for approval each quarter. He noted he presents to the AOC "proposed" revisions for their review, suggestions, questions and ultimately their approval.

Dr. Hughes stated they were on schedule with the current plan and had not encountered any significant delays.

Dr. Carlson asked if there were any material changes from the current report compared to the last report. Dr. Hughes stated no.

6. **Approve 1st Quarter FY 13-14 External Audit Activity Quarterly Status Report for the Quarter Ended September 30, 2013.**

Motion: Giancola; Second: Grimes, Yes-Nelson, Yes-Carlson, Yes-Cheng; Yes-D. Hughes (Proxy for Bates), Yes-Caporicci (Proxy for Wille), Absent-Freidenrich, Absent-Anderson, Absent-B. Hughes.

Approved as Recommended

Dr. Hughes introduced Mr. Michael Dean, Audit Manager over the external auditor reporting activity, to address the item.

Mr. Dean stated a few changes that were made from the prior quarter. "Contracted Audits" being performed by the Internal Audit Department for the District Attorney and the Treasurer-Tax Collector were added to the report. Dr. Hughes stated those audits were added to the report as requested from the last AOC meeting.

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Mr. Dean stated one material issue related to OC Flood Control District in OC Public Works was reported in the current quarter. Mr. Dean introduced Mr. James Tyler and Mr. Howard Thomas from OC Public Works to address the item.

Mr. Howard Thomas summarized the item. He said the County received funding from the State Department of Water Resources for the Santa Ana River Flood Control Project. At the time of submission, DWR determined eligibility of claims the County submitted. Later the State Controller's Office examined the claims as well and they up-held the DWR determination declining the County's initial claims. Mr. Thomas stated the County never received any funding as it was disallowed initially so there was nothing to reimburse. They did not identify any control weaknesses or any issues with the support the County provided.

Mr. Giancola asked what the ineligible "betterment costs" were. Mr. James Tyler said the betterment costs were related to bridge construction products. The bridge was lengthened because the river was widening. The County opted to add additional lanes when the widening was done and that was considered a betterment cost. Mr. Tyler explained the State was not obligated to compensate for the betterment condition.

Dr. Hughes said the issue wasn't about monies needing to be returned, it was about claims that were rejected. The Orange County Flood Control District was paying the costs. He stated this matter was presented in the spirit of full disclosure.

7. Receive and file Summary Highlights of Audit Reports Issued by Month for FY-13-14 July 1 to October 31, 2013
Item Received and Filed as Recommended

Mr. Caporicci asked why the CAAT routines were done monthly when there was high percentage of success with no exceptions. Dr. Hughes stated there was expressed support from the Auditor-Controller to maintain the reviews on monthly routine as an "assurance service" that the critical process was still operating as designed.

Ms. Jan Grimes, Auditor-Controller, asked if the Clerk-Recorder's (C-R) office would be revisited soon to follow up on the points raised in the 12D audit dealing with Special Revenues coming from transactional fees charged to support automation of property records. Dr. Hughes stated the six month follow-up audit review was planned. Mr. Alan Marcum, Senior Audit Manager, reported there had been almost daily interaction with the C-R's office. He said the Clerk-Recorder's office had sought guidance to be sure to address the recommendations and had been extremely transparent and diligent.

Dr. Carlson asked how much money flowed through the C-R. Dr. Hughes stated the C-R's annual budget was approximately \$41 million and \$3 million average funneled through the 12D Special Revenue Fund. Dr. Hughes stated the C-R originally had failed to use job coding to clearly identify the use of these Special Revenue Funds. In so far as the monies were to be used only for certain purposes, it was critical that they be accounted for through a reconstruction of such expenditures. Internal Audit was able to assist the C-R in reconstructing and presently C-R had justified over 90% of the expenditures. They were still completing the process of justifying the remaining 10%. Dr. Hughes stated misappropriations identified to date.

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Dr. Carlson asked where these types of reviews were identified in the audit schedule. Dr. Hughes stated, these types of reviews were included under the broad category titled Financial Audits & Mandates. Dr. Hughes stated that IAD was looking into other Special Revenue Funds and intended to include some more such audits in next year's audit plan. He stated the combined value of Special Revenue Funds was over \$1 billion. He noted almost all of those Special Revenue Funds had job costing codes in place to ensure how the money was spent which allowed for the funds to be audited unlike the C-R's 12D Fund.

Dr. Hughes stated he wanted to answer the question if there were more such situations in the County that were similar to Fund 12D. He said the analysis was not complete, but given the review to date, the evidence indicated there were not similar situations like Fund 12D in the County.

PUBLIC COMMENTS: None

AOC COMMENTS: None

ADJOURNMENT: 2:50 P.M.

NEXT MEETING: February 20, 2014, 11:30 a.m. REGULAR MEETING