

OPEN SESSION AGENDA ITEM

NOVEMBER 2018 AUDIT COMMITTEE ITEM III. A.

DATE: November 15, 2018

TO: **Members, Audit Committee**

FROM: John Adams, Chief Financial Officer

SUBJECT: **Presentation by and Discussion with Macias Gini & O'Connell (MGO)
Regarding the 2018 Fiscal Audit and Schedule**

EXECUTIVE SUMMARY

Cal Bus & Prof Code § 6145 (2007) provides that the board shall contract with an independent national or regional public accounting firm for an audit of its financial statements for each fiscal year beginning after December 31, 1998. The financial statements shall be promptly certified under oath by the Treasurer of the State Bar, and a copy of the audit and financial statement shall be submitted within 120 days of the close of the fiscal year to the Board, the Chief Justice of the Supreme Court, and to the Assembly and Senate Committees on Judiciary.

BACKGROUND

The Audit Committee is charged with assisting the Board of Trustees in fulfilling its oversight responsibility as related to the integrity of accounting and financial reporting processes, the system of internal controls, and audit processes. Current audit standards require the independent auditors to meet with the Audit Committee as described under the Statement on Auditing Standards (SAS #114 - The Auditor's Communication with Those Charged with Governance, and under SAS #115 - Communicating Internal Control Related Matters Identified in an Audit). The purpose is to communicate information to those charged with governing the State Bar of California in relation to the audit of financial statements. Specific items to be communicated include:

- Those charged with governance and management's responsibilities;
- The Auditor's responsibilities under generally accepted auditing standards;
- An overview of the planned scope and timing of the audit; and
- Significant findings from the audit (post audit).

DISCUSSION

Attached for your reference is the Auditor Engagement Letter which addresses the items above in more detail (Attachment 1). Additional discussion items are outlined below:

- Overview of the planned scope and timing of the audit:
 - Interim audit performed to start December 10, 2018; and
 - Year-end field work to start February 25, 2019
- Scope of audit includes:
 - Audited Annual Financial Report: As the independent auditor, MGO shall issue a two-year report on the fair presentation of the financial statements in conformity with generally accepted accounting principles as of and for the year ended December 31, 2017 and as of and for the year ended December 31, 2018. The auditor shall communicate in a letter to those charged with governance any material weakness or reportable conditions found during the audit, as defined by the generally accepted auditing standards. In addition, the following matters shall be reported to the Board of Trustees:
 - The auditor's responsibility under generally accepted auditing standards;
 - Significant accounting policies;
 - Management judgments and accounting estimates;
 - Significant audit adjustments;
 - Other information in documents containing audited financial statements;
 - Disagreements with management;
 - Management consultation with other accountants;
 - Major issues discussed with management prior to retention; and
 - Difficulties encountered in performing the audit
 - Special Examination and Deliverable (Receipts): In addition to the audit of the State Bar's financial statements, MGO will examine the State Bar's Statement of Expenditures of Mandatory Membership Fees (the "Statement") in accordance with generally accepted accounting standards for the years ended December 31, 2017 and December 31, 2018. This is to confirm the State Bar's compliance with the United States Supreme Court's decision on *Keller v. State Bar of California* (1990) 496 U.S. 1, which held that the State Bar cannot use mandatory fees paid by its members for political or ideological activities not related to regulations of the legal profession or improvement of the quality of legal services in California.

The Committee will be introduced to new accounting and auditing standards applicable to the State Bar this year including:

- GASB Statement No. 75 - Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions. GASB 75 addresses reporting by governments that provide Other Postemployment Benefits (OPEB) to their employees and for governments that finance OPEB for employees of other governments. For defined benefit OPEB, this Statement identifies the methods and assumptions that are required to be used to project benefit payments, discount projected benefit payments to their actuarial present value, and attribute that present value to periods of employee service. Note disclosure and required supplementary information requirements about defined benefit OPEB also are addressed. The Bar will implement GASB 75 effective December 31, 2018. This statement establishes standards for recognizing and measuring liabilities, deferred outflows of resources, deferred inflow of resources, and expense. The results will also include significant note disclosure and required supplementary information.
- GASB Statement No. 84 – Fiduciary Activities. GASB 84 establishes criteria for identifying fiduciary activities of all state and local governments. The focus of the criteria generally is on: 1) whether a government is controlling the assets of the fiduciary activity and 2) the beneficiaries with whom a fiduciary relationship exists. GASB 84 provides separate criteria to identify fiduciary component units and postemployment benefit arrangements that are fiduciary activities. If applicable, the Statement identifies four funds that should be reported: 1) pension (and other employee benefit) trust funds; 2) investment trust funds; 3) private-purpose trust funds; 4) custodial funds. GASB 84 requirements are effective for reporting periods beginning after December 15, 2018. The State Bar will evaluate this pronouncement and determine the fiscal impact on its 2019 financial statements.
- GASB Statement No. 87 – Leases. GASB 87 requires recognition of certain lease assets and liabilities for leases that previously were classified as operating leases and recognized as inflows of resources or outflows of resources based on the payment provisions of the contract. It establishes a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset. GASB 87 requirements are effective for reporting periods beginning after December 15, 2019. Earlier application is encouraged. The State Bar will evaluate this pronouncement and determine the fiscal impact on its 2020 financial statements.
- GASB Statement No. 88 – Certain Disclosures Related to Debt, Including Direct Borrowings and Direct Placements. GASB 88 defines debt for purposes of disclosure in notes to financial statements as a liability that arises from a contractual obligation to pay cash (or other assets that may be used in lieu of cash) in one or more payments to settle an amount that is fixed at the date the contractual obligation is established. The Statement requires that additional essential information related to debt be disclosed in notes to

financial statements, including unused lines of credit; assets pledged as collateral for the debt; and terms specified in debt agreements related to significant events of default with finance-related consequences, significant termination events with finance-related consequences, and significant subjective acceleration clauses. GASB 88 requirements are effective for reporting periods beginning after June 15, 2018. The State Bar will evaluate this pronouncement and determine the fiscal impact on its 2019 financial statements.

- Public Employees' Medical & Hospital Care Act (PEMHCA) implementation toward eligible retirees' purchase of medical insurance per state statute. PEMHCA is a lifetime retiree medical benefit required by CalPERS. The Bar's implementation of PEMHCA beginning May 1, 2018 represents a significant plan change that is impactful to the 2018 financial statements and required disclosures.

Lastly, the auditor would like to be advised of any areas of concern the Committee would like to have addressed during the year-end audit.

FISCAL/PERSONNEL IMPACT

None

RULE AMENDMENTS

None

BOARD BOOK AMENDMENTS

None

STRATEGIC PLAN GOALS & OBJECTIVES

Goal: 3. Improve the fiscal and operational management of the State Bar, emphasizing integrity, transparency, accountability, and excellence.

RECOMMENDATION

None

ATTACHMENT(S) LIST

- A.** Auditor Engagement Letter

November 7, 2018

To The Board of Trustees and Management
The State Bar of California
180 Howard Street
San Francisco, CA 94105

We are pleased to confirm our understanding of the services we are to provide the State Bar of California (State Bar) for the years ended December 31, 2018 and 2017. We will audit the financial statements of the State Bar, including the related notes to the financial statements, which collectively comprise the basic financial statements of the State Bar as of and for years ended December 31, 2018 and 2017. Accounting standards generally accepted in the United States of America provide for certain required supplementary information (RSI), such as management's discussion and analysis (MD&A), to supplement the State Bar's basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. As part of our engagement, we will apply certain limited procedures to the State Bar's RSI in accordance with auditing standards generally accepted in the United States of America. These limited procedures will consist of inquiries of management regarding the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We will not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance. The following RSI is required by U.S. generally accepted accounting principles and will be subjected to certain limited procedures, but will not be audited:

- 1) Management's Discussion and Analysis.
- 2) Pension related schedules.
- 3) OPED related schedules.

We have also been engaged to report on supplementary information other than RSI that accompanies the State Bar's financial statements. We will subject the following supplementary information to the auditing procedures applied in our audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America, and we will provide an opinion on it in relation to the financial statements as a whole, in a report combined with our auditor's report on the financial statements:

- 1) Program Funds Schedule of Net Position
- 2) Program Funds Schedule of Revenues, Expenses, and Changes in Net Position

In addition to our audit of the basic financial statements of the State Bar, our engagement will include an examination of the Statement of Expenditures of Mandatory Fees for the year ended December 31, 2018 and the State Bar's compliance with the United States Supreme Court's decision in *Keller v. State Bar of California* (1990) 496 U.S. 1, which held that the State Bar cannot use mandatory fees paid by its licensees for political or ideological activities not related to regulation of the legal profession or improvement of quality of legal services in California. Our examination will be conducted in accordance

with attestation standards established by the American Institute of Certified Public Accountants. Accordingly, the examination will include tests of records and other procedures we consider necessary to enable us to express an opinion as to whether the chargeable program expenditures of State Bar are presented, in all material respects, in conformity with the aforementioned requirements.

Audit Objective

The objective of our audit is the expression of opinions as to whether your financial statements are fairly presented, in all material respects, in conformity with generally accepted accounting principles and to report on the fairness of the supplementary information referred to in the second paragraph when considered in relation to the financial statements as a whole. Our audit will be conducted in accordance with auditing standards generally accepted in the United States of America and will include tests of the accounting records and other procedures we consider necessary to enable us to express such opinions. We will issue a written report upon completion of our audit of the State Bar's financial statements. Our report will be addressed to the Board of Trustees of the State Bar. We cannot provide assurance that unmodified opinions will be expressed. Circumstances may arise in which it is necessary for us to modify our opinions or add emphasis-of-matter or other-matter paragraphs. If our opinions are other than unmodified, we will discuss the reasons with you in advance. If, for any reason, we are unable to complete the audit or are unable to form or have not formed opinions, we may decline to express opinions or may withdraw from this engagement.

Audit Procedures—General

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; therefore, our audit will involve judgment about the number of transactions to be examined and the areas to be tested. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We will plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether from (1) errors, (2) fraudulent financial reporting, (3) misappropriation of assets, or (4) violations of laws or governmental regulations that are attributable to the government or to acts by management or employees acting on behalf of the government.

Because of the inherent limitations of an audit, combined with the inherent limitations of internal control, and because we will not perform a detailed examination of all transactions, there is a risk that material misstatements may exist and not be detected by us, even though the audit is properly planned and performed in accordance with U.S. generally accepted auditing standards. In addition, an audit is not designed to detect immaterial misstatements, or violations of laws or governmental regulations that do not have a direct and material effect on the financial statements. However, we will inform the appropriate level of management of any material errors, fraudulent financial reporting, or misappropriation of assets that comes to our attention. We will also inform the appropriate level of management of any violations of laws or governmental regulations that come to our attention, unless clearly inconsequential. Our responsibility as auditors is limited to the period covered by our audit and does not extend to any later periods for which we are not engaged as auditors.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts, and may include direct confirmation of receivables and certain other assets and liabilities by correspondence with selected individuals, funding sources, creditors, and financial institutions. We will request written representations from your attorneys as part of the engagement, and they may bill you for responding to this inquiry. At the conclusion of our audit, we will require certain written representations from you about the financial statements and related matters.

Audit Procedures—Internal Control

Our audit will include obtaining an understanding of the government and its environment, including internal control, sufficient to assess the risks of material misstatement of the financial statements and to design the nature, timing, and extent of further audit procedures. An audit is not designed to provide assurance on internal control or to identify deficiencies in internal control. Accordingly, we will express no such opinion. However, during the audit, we will communicate to management and those charged with governance internal control related matters that are required to be communicated under AICPA professional standards.

Audit Procedures—Compliance

As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we will perform tests of the State Bar's compliance with the provisions of applicable laws, regulations, contracts, and agreements. However, the objective of our audit will not be to provide an opinion on overall compliance and we will not express such an opinion.

Other Services

We will also assist in preparing the financial statements of the State Bar in conformity with U.S. generally accepted accounting principles based on information provided by you. We will perform the services in accordance with applicable professional standards. The other services are limited to the financial statement services previously defined. We, in our sole professional judgment, reserve the right to refuse to perform any procedure or take any action that could be construed as assuming management responsibilities.

Management Responsibilities

Management is responsible for designing, implementing, and maintaining effective internal controls relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error, including monitoring ongoing activities; for the selection and application of accounting principles; and for the preparation and fair presentation of the financial statements in conformity with U.S. generally accepted accounting principles.

Management is also responsible for making all financial records and related information available to us and for the accuracy and completeness of that information. You are also responsible for providing us with (1) access to all information of which you are aware that is relevant to the preparation and fair presentation of the financial statements, (2) additional information that we may request for the purpose of the audit, and (3) unrestricted access to persons within the government from whom we determine it necessary to obtain audit evidence.

Your responsibilities include adjusting the financial statements to correct material misstatements and confirming to us in the management representation letter that the effects of any uncorrected misstatements aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

You are responsible for the design and implementation of programs and controls to prevent and detect fraud, and for informing us about all known or suspected fraud affecting the government involving (1) management, (2) employees who have significant roles in internal control, and (3) others where the fraud could have a material effect on the financial statements. Your responsibilities include informing us of your knowledge of any allegations of fraud or suspected fraud affecting the government received in communications from employees, former employees, regulators, or others. In addition, you are responsible for identifying and ensuring that the government complies with applicable laws and regulations.

You are responsible for the preparation of the supplementary information in conformity with U.S. generally accepted accounting principles. You agree to include our report on the supplementary information in any document that contains and indicates that we have reported on the supplementary information. You also agree to include the audited financial statements with any presentation of the supplementary information that includes our report thereon. Your responsibilities include acknowledging to us in the representation letter that (1) you are responsible for presentation of the supplementary information in accordance with GAAP; (2) you believe the supplementary information, including its form and content, is fairly presented in accordance with GAAP; (3) the methods of measurement or presentation have not changed from those used in the prior period (or, if they have changed, the reasons for such changes); and (4) you have disclosed to us any significant assumptions or interpretations underlying the measurement or presentation of the supplementary information. With regard to the electronic dissemination of audited financial statements, including financial statements published electronically on your website, you understand that electronic sites are a means to distribute information and, therefore, we are not required to read the information contained in these sites or to consider the consistency of other information in the electronic site with the original document.

You agree to assume all management responsibilities for financial statement preparation services and any other nonattest services we provide; oversee the services by designating an individual, preferably from senior management, with suitable skill, knowledge, or experience; evaluate the adequacy and results of the services; and accept responsibility for them.

Engagement Administration, Fees, and Other

We understand that your employees will prepare all cash, accounts receivable, or other confirmations we request and will locate any documents selected by us for testing.

The audit documentation for this engagement is the property of Macias Gini & O'Connell LLP (MGO) and constitutes confidential information. However, subject to applicable laws and regulations, audit documentation and appropriate individuals will be made available upon request and in a timely manner to an appropriate regulator or its designee. We will notify you of any such request. If requested, access to such audit documentation will be provided under the supervision of MGO personnel. Furthermore, upon request, we may provide copies of selected audit documentation to an appropriate regulator or its designee. The regulator or its designee may intend or decide to distribute the copies or information contained therein to others, including other governmental agencies.

We expect to begin our audit on approximately December 10, 2018 and to issue our reports no later than April 25, 2019. David Bullock is the engagement partner and is responsible for supervising the engagement and signing the report or authorizing another individual to sign it.

Our fees for these services will be at our quoted hourly rates plus out-of-pocket costs, as outlined in the Financial Audit Agreement between the State Bar and MGO, effective October 9, 2018. Our quoted hourly rates vary according to the degree of responsibility involved and the experience level of the personnel assigned to your audit. Our invoices for these fees will be rendered each month as work progresses and are payable on presentation. In accordance with our firm policies, work may be suspended if your account becomes 60 days or more overdue and may not be resumed until your account is paid in full. If we elect to terminate our services for nonpayment, our engagement will be deemed to have been completed upon written notification of termination, even if we have not completed our report. You will be obligated to compensate us for all time expended and to reimburse us for all out-of-pocket costs through the date of termination. The fees are based on anticipated cooperation from your personnel and the assumption that unexpected circumstances will not be encountered during the audit. If significant additional time is necessary, we will discuss it with you and arrive at a new fee estimate before we incur the additional costs.

We appreciate the opportunity to be of service to the State Bar and believe this letter accurately summarizes the significant terms of our engagement. If you have any questions, please let us know. If you agree with the terms of our engagement as described in this letter, please sign the enclosed copy and return it to us.

Very truly yours,

Macias Gini & O'Connell LLP

Macias Gini & O'Connell LLP

RESPONSE:

This letter correctly sets forth the understanding of the State Bar.

Management signature: _____

Title: _____

Date: _____

Governance signature: _____

Title: _____

Date: _____