



The State Bar *of California*

OPEN SESSION AGENDA ITEM MAY 2019 AUDIT COMMITTEE III.A

DATE: May 16, 2019

TO: Members, Audit Committee

FROM: John Adams, Chief Financial Officer

SUBJECT: Presentation of 2018 Annual Financial Statements and Report of Independent Auditors by Macias Gini & O'Connell

EXECUTIVE SUMMARY

On April 29, 2019, the Audit Committee Chair and Vice Chair approved the filing of the Audited Financial Statements for year ended December 31, 2018. Business and Professions (B&P) Code section 6145(a) requires the statements to be sent by April 30 of each year to the Board of Trustees, the Chief Justice of the Supreme Court, and the Assembly and Senate Committees on Judiciary. The Audit Committee Charter assigns responsibility to the Audit Committee to review reports of external auditors. This report provides the audit reports to the Audit Committee for discussion and communications with the external auditor.

BACKGROUND

The State Bar's annual financial audit was conducted by the independent accounting firm of Macias Gini & O'Connell. Macias Gini & O'Connell was appointed the State Bar's external independent auditors in September 2018. David Bullock, Partner with Macias Gini & O'Connell, met with the Audit Committee in November 2018 to discuss the scope and responsibilities of the audit. On April 29, 2019, Macias Gini & O'Connell issued their reports on the following financial statements for the year ended December 31, 2018.

- Annual Audited Financial Statements; and
- Statement of Expenditures of Mandatory Fees.

The auditor's opinion on each of these financial statements is unmodified. Both sets of financial statements and related auditor's reports are required to be filed with the State Legislature and Supreme Court by April 30 of each year.

On April 25 & 29, 2019, the Audit Committee Chair and Vice Chair had conference calls with David Bullock to review and discuss the financial statements and auditor's report. On April 29, 2019, they authorized staff to file the audited financial statements for year ended December 31, 2018 with the Legislature and Supreme Court. On April 30, staff completed the legislative filing of the audited statements.

The State Bar's Annual Audited Financial Statements and Statement of Expenditures of Mandatory Fees for the year ended December 31, 2018, along with the independent auditor's report from Macias Gini & O'Connell are located on the State Bar Website ([2018 Financial Report Filing](#)).

DISCUSSION

A. Annual Audited Financial Statements & Independent Auditor's Report

Business and Professions Code section 6145(a) require the State Bar to undergo an audit of its financial statements by an independent accounting firm each year. The audit is to be completed and submitted to the Board of Trustees, the Chief Justice of the Supreme Court and to the Assembly and Senate Committees on Judiciary by April 30 each year.

The Business and Professions Code also requires the Annual Audited Financial Statements to be certified under oath by the chief financial officer of the State Bar. This certification has been completed by John Adams, Chief Financial Officer.

B. Statement of Expenditures of Mandatory Fees

To comply with the constitutional requirements for collection of mandatory membership fees under *Keller v. State Bar of California*, 496 U.S. 1 (1990), the State Bar must prepare each year an audited statement of its major categories of expenses showing that no mandatory fees were used for political or ideological activities not "necessarily or reasonably incurred for the purpose of regulating the legal profession or improving the quality of legal services available to the people of the State." The purpose of the Statement of Expenses of Mandatory Fees is to provide an explanation of the mandatory licensing fees that each State Bar licensee must pay under state law in order to practice law in California. It describes and separates expenses of mandatory licensing fees by program into "chargeable" and "non-chargeable" categories.

Because of the deductions for the full expenses of these programs and the State Bar's policy to fund them solely with voluntary revenues received from licensees electing not to take the deductions, the statement does not present any "non-chargeable" activities that are supported by the mandatory portion of the annual licensing fees. The statement is prepared using the State Bar's most recently completed audited financial statement and shows the major

categories of expenses with a brief description of each category so that each State Bar licensee may gauge whether the expense is justified under the Keller standard. An independent auditor must verify the Statement of Expenses of Mandatory Fees. The Statement of Expenses of Mandatory Licensing Fees is then published by posting on the State Bar website at www.calbar.ca.gov and notice in the annual licensee billing statement to State Bar licensees.

C. Report to the Audit Committee and the Board of Trustees

The Audit Committee is chartered to assist 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 #115 – Communicating Internal Control Related Matters Identified in an Audit). The auditor shall communicate in a report 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:

- The auditor’s responsibility under generally accepted auditing standards;
- Significant accounting policies;
- Management judgments and accounting estimates;
- Significant audit adjustments;
- Disagreements with management;
- Management consultation with other accountants;
- Major issues discussed with management prior to retention; and
- Difficulties encountered in performing the audit.

Attached is the Report to the Audit Committee and Board of Trustees which addresses the items above in more detail (Attachment A).

FISCAL/PERSONNEL IMPACT

None

RULE AMENDMENTS

None

BOARD BOOK AMENDMENTS

None

STRATEGIC PLAN GOALS & OBJECTIVES

None - compliance

RECOMMENDATIONS

It is recommended that the Board's Audit Committee affirm the filing of the State Bar's audited statements and related auditor's reports for the year ended December 31, 2018 with the State Legislature and the Supreme Court.

WHEREAS, the Board's Audit Committee Chair and Co-Chair are authorized to review the draft audited statements and direct staff to submit them to the Legislature and Supreme Court on behalf of the Board of Trustees;

AND WHEREAS, on April 25, 2019, the Board Audit Committee Chair and Co-Chair received the draft financial statements and directed staff on April 29, 2019 to file the audited statements for year ended December 31, 2018, with the Legislature and Supreme Court; it is hereby

RESOLVED, that the Board's Audit Committee hereby affirms the action taken by the Chair and Co-Chair, on behalf of the Board; and it is

FURTHER RESOLVED, that upon the recommendation of the Audit Committee, the Board hereby receives the Annual Audited Financial Statements and the Statement of Expenditures of Mandatory Fees for the year ended December 31, 2018, and the accompanying independent auditor's reports.

ATTACHMENT(S) LIST

- A.** Report to the Audit Committee and the Board of Trustees

STATE BAR OF CALIFORNIA

**REPORT TO THE
AUDIT COMMITTEE AND
THE BOARD OF TRUSTEES**

FOR THE YEAR ENDED DECEMBER 31, 2018



Certified
Public
Accountants

STATE BAR OF CALIFORNIA
Report to the Audit Committee and the Board of Trustees
For the Year Ended December 31, 2018

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To the Audit Committee and the
Board of Trustees of the State Bar of California
San Francisco, California

In planning and performing our audit of the basic financial statements of the State Bar of California (the State Bar), as of and for the year ended December 31, 2018, in accordance with auditing standards generally accepted in the United States of America, we considered the State Bar's internal control over financial reporting (internal control) as a basis for designing audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the basic financial statements, but not for the purpose of expressing an opinion on the effectiveness of the State Bar's internal control. Accordingly, we do not express an opinion on the effectiveness of the State Bar's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses. Given these limitations during our audit, we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

We did observe a control deficiency, included as item number 2018-001, that we did not consider to be a material weakness or significant deficiency. The State Bar's written responses to the comment and recommendation identified are described in the Schedule of Comment and Response section. The State Bar's response was not subjected to the auditing procedures applied in our audit of the financial statements. We did not audit the State Bar's response and, accordingly, we express no opinion on it. In addition, we would be pleased to discuss the recommendation in further detail at your convenience, to perform any additional study of these matters, or to assist you in implementing this recommendation.

We would like to thank State Bar management and staff for the courtesy and cooperation extended to us during the course of our engagement.

This communication is intended solely for the information and use of the Audit Committee, Board of Trustees, State Bar management, and others within the organization, and is not intended to be, and should not be, used by anyone other than these specified parties.

Very truly yours,

San Francisco, California
April 29, 2019

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Report to the Audit Committee and the Board of Trustees
For the Year Ended December 31, 2018

REQUIRED COMMUNICATIONS

We have audited the financial statements of the governmental activities, each major fund, and the aggregate remaining fund information of the State Bar of California (State Bar), as of and for the year ended December 31, 2018. Professional standards require that we provide you with information about our responsibilities under generally accepted auditing standards, as well as certain information related to the planned scope and timing of our audit. We have previously communicated such information to you in our engagement letter dated November 7, 2018. Professional standards also require that we communicate to you the following information related to our audit.

Significant Audit Findings

Qualitative Aspects of Accounting Practices

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by the State Bar are described in Note 3 to the basic financial statements. As described in Note 3 to the financial statements, the State Bar implemented four new Governmental Accounting Standards Board (GASB) pronouncements in 2018: Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*; Statement No. 81, *Irrevocable Split-Interest Agreements*; Statement No. 85, *Omnibus 2017*; and Statement No. 86, *Certain Debt Extinguishment Issues*. However, only GASB 75 had a significant impact to the State Bar's accounting and financial reporting as a result of implementing these standards.

We noted no transactions entered into by the State Bar during the year for which there is a lack of authoritative guidance or consensus. All significant transactions have been recognized in the financial statements in the proper period.

Accounting estimates are an integral part of the financial statements prepared by management and are based on management's knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ significantly from those expected. The most sensitive estimates affecting the financial statements were:

Fair value of investments. Management's investments are generally carried at fair value, which is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The State Bar's investments are classified as level 1 and level 2 of the fair value hierarchy established by GASB Statement No. 72. Investments classified in level 1 are valued using prices quoted in active markets for those securities. U.S. government securities, corporate bonds, and municipal bond classified in level 2 are valued using a matrix pricing technique. Matrix pricing is used to value securities based on the securities' relationship to benchmark quoted prices.

Estimated allowance for doubtful accounts on accounts receivable. The allowance for losses on accounts receivable was based on management's estimate regarding the likelihood of collectability.

Valuation of net pension liability, pension expense and pension related deferred inflows and outflows of resources. The net pension liability, pension expense and pension related deferred inflows and outflows of resources are a product of the CalPERS actuarial valuation as of June 30, 2017, rolled forward to June 30, 2018 for the CalPERS plan. The Plan is an agent multiple-employer plan administered by CalPERS, which acts as a common investment and administrative agent for participating entities with the State of California.

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Valuation of net OPEB asset, OPEB expense and OPEB related deferred outflows of resources. The net OPEB asset, OPEB expense and OPEB related deferred outflows of resources are a product of State Bar's independent actuarial valuation as of January 1, 2018, rolled forward to June 30, 2018 for the OPEB plan. The Plan is an agent multiple-employer plan administered by CalPERS, which acts as a common investment and administrative agent for participating entities with the State of California.

Estimated useful lives and depreciation methods assigned to depreciable capital assets. The estimated useful lives of capital assets were determined by management based on the nature of the capital assets. The State Bar uses the straight line method of depreciation.

We evaluated the key factors and assumptions used to develop these estimates in determining that the estimates are reasonable in relation to the financial statements taken as a whole.

Certain financial statements disclosures are particularly sensitive because of their significance to financial statement users. The most sensitive disclosures affecting the financial statements were the disclosure of the Pension Plan (Note 8) and the Other Postemployment Benefits (Note 9 and 10).

The financial statement disclosures are neutral, consistent, and clear.

Difficulties Encountered in Performing the Audit

We encountered no difficulties in dealing with management in performing and completing our audit.

Corrected and Uncorrected Misstatements

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. The attached schedule summarizes an uncorrected misstatement of the financial statements. Management has determined that its effect is immaterial to the financial statements taken as a whole. In addition, none of the misstatements detected as a result of audit procedures and corrected by management were material, either individually or in the aggregate, to the basic financial statements. Management has corrected all such misstatements.

Disagreements with Management

For purposes of this letter, professional standards define a disagreement with management as a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

Management Representations

We have requested certain representations from management that are included in the Management Representation Letter dated April 29, 2019.

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Management Consultations with Other Independent Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a “second opinion” on certain situations. If a consultation involves application of an accounting principle to the governmental unit’s financial statements or a determination of the type of auditor’s opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

Other Audit Findings or Issues

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the State Bar’s auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention.

Other Information in Documents Containing Audited Financial Statements

Our responsibility for other information in documents containing the basic financial statements and our report does not extend beyond the financial statements identified in our audit report. We do not have an obligation to perform any procedures to corroborate other information contained in these documents.

Other Matters

We applied certain limited procedures to Management’s Discussion and Analysis, Schedule of Changes in Net Pension Liability and Related Ratios, Schedule of Plan Contributions – Pension, Schedule of Changes in Net OPEB Liability (Asset) and Related Ratios, Schedule of Contribution – OPEB Plan, and Schedule of Funding Progress – OPEB Plan, which are required supplementary information (RSI) that supplements the basic financial statements. Our procedures consisted 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 did not audit the RSI and do not express an opinion or provide any assurance on the RSI.

We were engaged to report on combining financial statements and other supplementary information, which accompany the financial statements but are not RSI. With respect to this supplementary information, we made certain inquiries of management and evaluated the form, content, and methods of preparing the information to determine that the information complies with accounting principles generally accepted in the United States of America, the method of preparing it has not changed from the prior period, and the information is appropriate and complete in relation to our audit of the financial statements. We compared and reconciled the supplementary information to the underlying accounting records used to prepare the financial statements or to the financial statements themselves.

We were not engaged to report on the introductory and statistical sections, which accompany the financial statements but are not RSI. We did not audit or perform other procedures on this other information and we do not express an opinion or provide any assurance on it.

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SCHEDULE OF COMMENT AND RESPONSE

Finding 2018-001 – Internal Control Deficiencies
Improve Internal Controls Over the Financial Reporting

Internal control is an integral process that is effected by the State Bar's governing body, management and personnel and is designed to address risks and to provide reasonable assurance that in pursuit of the organization's goals, the following general objectives are being achieved:

- Executing orderly, ethical, economical, efficient and effective operations;
- Fulfilling accountability obligations;
- Complying with applicable laws, regulations, contracts and grant agreements; and
- Safeguarding resources against loss, misuse and damage.

Internal control is a dynamic integral process that should be continuously adapting to the changes faced by State Bar. As part of our audit procedures, we assess an organization's environment, risk assessment and monitoring of controls to determine whether internal controls have been effective over financial reporting. If controls do not exist, are poorly designed or not operating effectively, we must evaluate the control deficiencies and report the deficiencies to management and, when applicable, report deficiencies to those charged with governance. During our audit, we noted the following deficiencies of internal control over the financial reporting:

- Accounting & Reporting Delays – During the audit year, the State Bar experienced turnover or vacancy in its key management positions. We observed that the State Bar experienced significant delays in its accounting and reporting processes due to an understaffed Finance Department. The turnover and vacancy required other employees or consultants perform the additional duties while still completing their own work.
- Accounts Receivable – The State Bar did not have adequate reviews over the reconciliation between accounts receivable and cash collections for the 2018 Billing Cycle. This resulted in \$1.08 million adjustment to reduce accounts receivable balance for fees already recognized in the previous fiscal year.

The State Bar has made an investment in improving its financial reporting process over the past year. The State Bar should initiate a comprehensive analysis on its financial reporting processes and document its risk assessment policies and procedures for each significant transaction cycle. In addition, the State Bar should continue to incorporate the skills and experience of its new personnel assigned to key roles in the preparation of the annual financial statements to improve the efficiency of its financial reporting process, including cross-training to minimize the impacts of further turnover.

Management Response

Accounting & Reporting Delays – There were key vacancies in the Office of Finance in 2018. Several of these positions have been filled in the last 6-8 months, including a new Chief Financial Officer. In addition to these staffing changes, the delay in getting the new audit agreement executed impacted the schedule and the interim audit start date. The fact that it was Macias Gini & O'Connell's (MGO) first year conducting the audit added to the complexities of completing the audit in a timely fashion. With the 2019 interim audit scheduled to begin in August, and this being the second year that MGO will complete it, staff anticipates an efficient and timely audit.

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Accounts Receivable – During the 2018 licensee billing cycle, from December 1, 2017, to February 1, 2018, the My State Bar Profile (MSBP) system in some instances incorrectly charged licensees who used credit cards multiple times. These duplicate payments were captured in the General Ledger as credit card payments deposited to the bank, but were not captured in the Koala billing system. Accordingly, these fees were not recognized as deferred revenue for fiscal year 2018 collected in December of 2017, but instead as revenue in fiscal year 2017.

At the completion of the 2018 billing cycle and reconciliation of the 2018 licensee fee revenue as part of the year-end audit process, it was identified that duplicate payments were posted and recognized as revenue in December of 2017. Those payments were refunded in 2018 and posted to Accounts Receivable. Based on the early recognition of the duplicate payments and the corresponding refunds, an expense was recorded in 2018 to offset the accounts receivable account.

The tables below show the initial entry and the correcting entry.

<u>Incorrect General Ledger Entry</u>	<u>Debit</u>	<u>Credit</u>
Duplicate Payments in December 2017	Cash Account (A)	2017 Revenue (R)
Refunds in 2018	Accounts Receivable (A)	Cash Account(A)

<u>Correcting General Ledger Entry</u>	<u>Debit</u>	<u>Credit</u>
Adjusting Prior Revenue	Expenses (E)	Accts Receivable (A)

The table below shows the appropriate accounting treatment.

<u>Appropriate Accounting Treatment</u>	<u>Debit</u>	<u>Credit</u>
Duplicate Payments in December 2017	Cash Account (A)	Deferred Revenue (L)
Refunds in 2018	Deferred Revenue (L)	Cash Account (A)

For the 2019 billing cycle, additional controls have been put into place including the daily reconciliations between the billing system and the General Ledger. As the State Bar implements a new Financial System in 2019 and starts implementing a new Licensee Management System (LIMS), the processes will be streamlined with better controls.

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Summary of Uncorrected Financial Statement Misstatement

Number	Fund	Account Name	Debit	Credit
PAJE1	Fund 10	Beginning Net Position	\$ 1,075,987	\$ -
PAJE1	Fund 10	Miscellaneous Expense	-	1,075,987
			<u>\$ 1,075,987</u>	<u>\$ 1,075,987</u>

To record a prior period adjustment for membership fees already collected in fiscal year 2017.