

Internal Audit Department

O R A N G E C O U N T Y
6th Largest County in the USA

Financial and Mandated Audit: COMMUNITY FACILITIES DISTRICTS/ MELLO-ROOS

For the Period July 1, 2012
through June 30, 2013

Key Control Audit

CEO/Public Finance disbursed approximately \$72 million for debt service, acquisition, and construction costs during the audit period.

We audited CEO's and CEO/Public Finance Accounting's Community Facilities Districts/Mello-Roos process to evaluate whether internal controls are in place and working effectively to ensure: 1. Special tax rates are calculated in accordance with pertinent governing documentation; 2. Bond proceeds are used for projects in compliance with pertinent governing documentation, and 3. The process is efficient and effective (e.g., no backlogs, duplication of work, manual processes that could benefit from automation).

Our audit found controls and processes in place to ensure special tax rates and bond proceeds are calculated and utilized in accordance with pertinent governing documentation. Our audit identified **two (2) Control Findings** to improve controls regarding estimating administrative costs in the special tax levy calculation and monitoring project costs in accordance with the Acquisition, Funding, and Disclosure Agreements.

AUDIT NO: 1317

REPORT DATE: JANUARY 9, 2014

Director: Dr. Peter Hughes, MBA, CPA, CIA
Senior Audit Manager: Alan Marcum, CPA, CIA
Audit Manager: Lisette Free, CPA, CFE

RISK BASED AUDITING

GAO & IIA Peer Review Compliant – 2001, 2004, 2007, 2010



American Institute of Certified Public Accountants Award to Dr. Peter Hughes as 2010 Outstanding CPA of the Year for Local Government

GRC (Government, Risk & Compliance) Group 2010 Award to IAD as MVP in Risk Management



2009 Association of Certified Fraud Examiners' Hubbard Award to Dr. Peter Hughes for the Most Outstanding Article of the Year – Ethics Pays



2008 Association of Local Government Auditors' Bronze Website Award



2005 Institute of Internal Auditors' Award to IAD for Recognition of Commitment to Professional Excellence, Quality, and Outreach

 ORANGE COUNTY BOARD OF SUPERVISORS'
Internal Audit Department

GAO & IIA Peer Review Compliant - 2001, 2004, 2007, 2010

Providing Facts and Perspectives Countywide

RISK BASED AUDITING

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Director

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To access and view audit reports or obtain additional information about the OC Internal Audit Department, visit our website: www.ocgov.com/audit



OC Fraud Hotline (714) 834-3608

Letter from Dr. Peter Hughes, CPA



Transmittal Letter



Audit No. 1317 January 9, 2014

TO: Michael B. Giancola, County Executive Officer
Jan Grimes, Auditor-Controller

FROM: Dr. Peter Hughes, CPA, Director
Internal Audit Department

SUBJECT: Financial and Mandated Audit:
Community Facilities Districts/Mello-Roos

We have completed a Financial and Mandated Audit of Community Facilities Districts/Mello-Roos Process for the period July 1, 2012 through June 30, 2013. We performed this audit in accordance with our *FY 2013-14 Audit Plan and Risk Assessment* approved by the Audit Oversight Committee and the Board of Supervisors. Our final report is attached for your review.

Please note we have a structured and rigorous **Follow-Up Audit** process in response to recommendations and suggestions made by the Audit Oversight Committee (AOC) and the Board of Supervisors (BOS). Our **First Follow-Up Audit** will begin at six months from the official release of the report. A copy of all our Follow-Up Audit reports is provided to the BOS as well as to all those individuals indicated on our standard routing distribution list.

The AOC and BOS expect that audit recommendations will typically be implemented within six months and often sooner for significant and higher risk issues. Our **Second Follow-Up Audit** will begin at six months from the release of the first Follow-Up Audit report, by which time **all** audit recommendations are expected to be addressed and implemented. At the request of the AOC, we are to bring to their attention any audit recommendations we find still not implemented or mitigated after the second Follow-Up Audit. The AOC requests that such open issues appear on the agenda at their next scheduled meeting for discussion.

We have attached a **Follow-Up Audit Report Form**. Your department should complete this template as our audit recommendations are implemented. When we perform our first Follow-Up Audit approximately six months from the date of this report, we will need to obtain the completed document to facilitate our review.

Each month I submit an **Audit Status Report** to the BOS where I detail any material and significant audit findings released in reports during the prior month and the implementation status of audit recommendations as disclosed by our Follow-Up Audits. Accordingly, the results of this audit will be included in a future status report to the BOS.

As always, the Internal Audit Department is available to partner with your staff so that they can successfully implement or mitigate difficult audit recommendations. Please feel free to call me should you wish to discuss any aspect of our audit report or recommendations. Additionally, we will request your department complete a **Customer Survey** of Audit Services. You will receive the survey shortly after the distribution of our final report.

ATTACHMENTS

Other recipients of this report are listed on the **OC Internal Auditor's Report** on page 7.

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Community Facilities Districts/Mello-Roos
Audit No. 1317*

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Audit No. 1317

January 9, 2014

TO: Michael B. Giancola, County Executive Officer
Jan Grimes, Auditor-Controller

FROM: Dr. Peter Hughes, CPA, Director
Internal Audit Department

SUBJECT: Financial and Mandated Audit: Community Facilities
Districts/Mello-Roos

OBJECTIVES

In accordance with our *FY 2013-14 Audit Plan and Risk Assessment* approved by the Audit Oversight Committee and the Board of Supervisors, the Internal Audit Department conducted a Financial and Mandated Audit of the Community Facilities Districts/Mello-Roos Process. Our audit included an evaluation of internal controls, testing compliance with CEO/Public Finance (CEO/PF), CEO/Public Finance Accounting (CEO/PFA) and County policies; and evaluating process efficiencies and effectiveness. Our audit was conducted in conformance with the International Standards for the Professional Practice of Internal Auditing prescribed by the Institute of Internal Auditors as required by California Government Code, Section 1236. The objectives of this audit were to evaluate whether internal controls over Community Facilities Districts are in place and working effectively to ensure:

1. Special tax rates are calculated in accordance with pertinent governing documentation.
2. Bond proceeds are used for projects in compliance with pertinent governing documentation.
3. The process is efficient and effective (e.g., no backlogs, duplication of work, manual processes that could benefit from automation).

RESULTS

Objective #1: Our audit found internal controls are in place to ensure special tax rates are calculated in accordance with pertinent governing documentation. We identified **one (1) Control Finding** regarding estimating administrative costs in the special tax levy calculations by utilizing available historical data.

Objective #2: Our audit found internal controls are in place to ensure bond proceeds are used for projects in compliance with pertinent governing documentation. We identified **one (1) Control Finding** regarding monitoring project costs in accordance with the Acquisition, Funding and Disclosure Agreements.

Objective #3: Our audit did not note any duplication of work or processes that could be automated.

Audit Highlight

Community Facilities Districts/ Mello-Roos for debt service, acquisition, and construction costs from July 1, 2012 through June 30, 2013 totaled **\$72 million**.

Our audit found processes in CEO/PF and CEO/PF Accounting are in place to ensure special tax rates are calculated in accordance with pertinent governing documentation.

We identified **two (2) Control Findings** concerning estimating administrative costs in the special tax levy calculation and monitoring project costs in accordance with the Acquisition, Funding, and Disclosure Agreements.

OC Internal Auditor's Report



The following table summarizes our findings and recommendations for this audit. See further discussion in the *Detailed Results, Findings, Recommendations and Management Responses* section of this report. See *Attachment A* for a description of Report Item Classifications.

Finding No.	Finding Classification (see Attachment A)	Finding and Page No. in Audit Report	Recommendation	Concurrence by Management?
1.	Control Finding	Estimating Administrative Costs. Our testing disclosed for the most recent annual special tax levy calculation, FY 12/13 actual administrative expense information was available and therefore, should have been used as the basis for the FY 13/14 estimate of administrative costs (pg. 9).	We recommend CEO/Public Finance Accounting calculate the Special Tax Requirement in accordance with the Rate and Method of Apportionment by consistently and reasonably applying actual administrative expenses or reasonable estimates based on the most recently available data.	Yes
2.	Control Finding	Monitoring Project Costs. Internal controls over monitoring project costs could be strengthened (pg. 11): 1. CFD's Project Cost Reports and Statement of Sources and Uses are not complete and up-to-date. 2. We noted costs are not consistently applied to Project Cost Reports. 3. Reconciliations between the Statement of Sources and Uses and the Project Cost Reports are not performed.	We recommend CEO/Public Finance Accounting develop procedures to ensure Project Cost Reports and Statement of Sources and Uses Reports are prepared timely and reflect an accurate accounting of remaining available cash balances. In addition, we recommend CEO/PFA complete a reconciliation between the Project Cost Reports and Statement of Sources and Uses to the General Ledger on a regular basis to ensure all project costs (including those costs not directly charged against a specific cost category) are properly recorded.	Yes



BACKGROUND

The Mello-Roos Community Facilities Act of 1982

In 1978, Californians enacted Proposition 13 which limited the ability of local public agencies to increase property taxes based on a property's assessed value. In 1982, the Mello-Roos Community Facilities Act of 1982 (Government Code §53311-53368.3) was created to provide an alternate method of financing needed improvements and services.

The Mello-Roos Community Facilities Act allows any county, city, special district, school district or joint powers authority to establish a Mello-Roos Community Facilities District (a "CFD") which allows for financing of public improvements and services. The services and improvements that Mello-Roos CFDs can finance include streets, sewer systems and other basic infrastructure, police protection, fire protection, ambulance services, schools, parks, libraries, museums and other cultural facilities. By law, the CFD is also entitled to recover expenses needed to form the CFD and administer the annual special taxes and bonded debt.

By law, (Prop 13), the Special Tax cannot be directly based on the value of the property. Special Taxes instead are based on mathematical formulas that take into account property characteristics such as use of the property, square footage of the structure and lot size. The formula is defined at the time of formation, and will include a maximum special tax amount and a percentage maximum annual increase.

Government Code (Section 53311, et seq.)

The California Government Code Sections 53311-53368.3 governs the Mello-Roos Community Facilities Act of 1982.

CEO/Public Finance

The Chief Financial Officer (CFO) ensures the financial stability of the County by managing all financial functions in an efficient, cost-effective and responsive manner. The Orange County Public Finance Division is primarily responsible for managing the County's public debt programs. Public debt programs are designed to access funds for the construction and acquisition of public facilities (airports, courts, schools, etc.) and infrastructure needs (roads, bridges, storm drains, etc.), and the implementation of programs targeted for the well-being of the community (housing programs for low-income residents, etc.).

CEO/Public Finance is part of the County Executive Office (CEO) under the leadership and oversight of the Chief Financial Officer (CFO) and Director CEO/Public Finance. CEO/Public Finance is primarily responsible for managing the County's public debt programs, including Community Facilities Districts (CFDs).

CEO/Public Finance Accounting

CEO/Public Finance Accounting (PFA) is one of the Auditor-Controller's Satellite Accounting Operations (Auditor-Controller PFA). Auditor-Controller PFA is primarily responsible for providing specialized accounting support/services in accordance with the complex needs of CEO/Public Finance. An Accounting Services Agreement is in place between the CEO and Auditor-Controller. The Accounting Services Agreement was signed during the second quarter of calendar year 2008.

Public Financing Advisory Committee (PFAC)

The PFAC is comprised of five public voting members, the Treasurer-Tax Collector, Auditor-Controller and one non-voting ex-officio County government member (the County Executive Officer).



The PFAC's purpose is to:

- Review, approve, modify or deny debt financing proposals. No debt financing proposal is considered by the Board of Supervisors unless specifically recommended in writing by the PFAC;
- Select, subject to ratification by the Board of Supervisors, all financing professionals required to assist in the structuring of public financings (bond counsel, underwriters, trustees, financial advisors, etc.);
- Review and approve all debt financing documents;
- Ensure that a written plan of due diligence is completed for each public financing, and ensure that the plan of due diligence provides reasonable assurance that the Official Statement and other disclosure documents utilized in connection with a public financing is in compliance with all applicable state and federal laws; and
- Ensure full and fair disclosure of actual or potential conflicts of interest resulting from financial and other relationships among financing professionals and the County or other County related issuer.

The County of Orange Bond Proceeds

In order to provide a more flexible funding source to local governments, the State Legislature enacted the Mello-Roos Act (Act) in 1982. The Act permits landowners, upon receiving approval from a local government agency, to form a CFD to levy a special tax, and to authorize bonds secured by the special tax. As the properties in the CFD are developed and sold, new homebuyers assume the responsibility for paying the Mello-Roos special tax which is included on their property tax bills. The Act has been used by local governments to finance infrastructure in communities to date. It has become one of the primary funding sources for constructing public facilities which are needed to serve development projects throughout the State.

The County's Community Facilities Districts/Mello-Roos are designed to fund required infrastructure (e.g., roads, storm drains, fire stations, libraries, schools, airport improvements) to support current and future residential and commercial growth within land-based taxing regions called CFDs. Funds for CFDs' needs are generated through the issuance of bonds by each CFD. Payment to investors of CFD bonds is made through special taxes levied on real property within the districts according to the Rate and Method of Apportionment of the Special Taxes approved by qualified electors of the CFD. The burden of the special taxes falls on the property owners within the districts. Debt service is secured by special tax liens on the property in each CFD. Failure to pay special taxes can result in judicial foreclosure. Auditor-Controller PFA provides accounting services for the CFD's debt service, acquisition and construction activities.

For fiscal year 2012-13, the County of Orange has the following issued and outstanding bonds on behalf of the Community Facilities Districts/Mello-Roos pursuant to the terms and provisions of the Mello-Roos Community Facilities Act of 1982 (Government Code section 53311, et seq.):

Bond	Bond Description	Aggregate Principal Amount	Maturity Year	Outstanding as of 6/30/13
1.	CFD No. 86-2 (Rancho Santa Margarita) of the County of Orange Series A of 1998 Special Tax Bonds	\$10,975,000	2017	\$ 5,980,000
2.	CFD No. 86-2 (Rancho Santa Margarita) of the County of Orange Series A of 2001 Special Tax Bonds	8,005,000	2017	1,100,000
3.	South Orange County Public Financing Authority Special Tax Revenue Bonds 1998 Series B (Junior Lien Bonds)	29,010,000	2013	1,165,000
4.	South Orange County Public Financing Authority Special Tax Revenue Refunding Bonds 2003 Series A (Senior Lien Bonds)	49,845,000	2016	30,290,000

OC Internal Auditor's Report



Bond	Bond Description	Aggregate Principal Amount	Maturity Year	Outstanding as of 6/30/13
5.	South Orange County Public Financing Authority Special Tax Refunding Bonds 2004 Series A (Foothill Area)	92,370,000	2019	63,715,000
6.	South Orange County Public Financing Authority Special Tax Revenue Bonds 2005 Series A (Ladera Ranch)	84,015,000	2032	73,950,000
7.	CFD No 87-4 of the County of Orange (Foothill Ranch) Series A of 1997 Special Tax Bond	10,815,000	2019	5,865,000
8.	South Orange County Public Financing Authority Special Tax Revenue Bonds 1998 Series A (Portolla Hills/Lomas Laguna)	25,855,000	2016	4,870,000
9.	South Orange County Public Financing Authority Special Tax Revenue Bonds 1999 Series A	75,920,000	2018	23,190,000
10.	South Orange County Public Financing Authority Special Tax Revenue Bonds 1999 Series B	2,335,000	2014	475,000
11.	CFD No. 02-1 of the OC (Ladera Ranch) Series A of 2003 Special Tax Bonds	68,280,000	2033	64,495,000
12.	CFD No. 03-1 of the OC (Ladera Ranch) Series A of 2004 Special Tax Bonds	57,185,000	2034	54,825,000
13.	CFD No. 04-1 of the OC (Ladera Ranch) Series A of 2005 Special Tax Bonds	75,645,000	2034	71,745,000
	TOTAL	\$590,255,000		\$401,665,000

Note: Many of the original CFD's were refunded.

The County of Orange maintains two funds to account for each of the CFDs' activities: 1) a debt service fund, and 2) an acquisition and construction fund. The CFDs' debt service funds are utilized to account for the bond's proceeds for debt service activities (i.e., special taxes, interest, principal, redemption, reserve, rebate and administrative expenses). The CFDs' acquisition and construction funds are utilized to account for the bonds' proceeds for the required infrastructure and services (i.e., maintenance). The County maintains a chart of accounts to designate the CFDs' funds.

The bonds' Official Statements and Supplements to the Resolutions provides information concerning the issuance and sale along with the terms governing the bonds, specifically the process for receiving and transferring bond proceeds by the CFDs. Other relevant documents related to CFD's include, but are not limited to the following:

- Official Statement-Bond Issuance (OS) includes Debt Service Schedules
- BOS Resolutions (establish CFD & authorize the levy of special taxes)
- Engineering Reports
- Acquisition, Funding & Disclosure Agreements
- Rate & Method of Apportionments (Appendix to OS and approved by owners at special election and adopted and approved by BOS)
- CFD Annual Administration Report, prepared by an external consultant (includes rate calculation)



Teeter Plan Obligations Notes, Series B

The County issued \$57,935,000 Teeter Plan Obligations Notes which in part guarantees the special tax charge (County pays the CFD up front for the special tax charged for the year. County collects special tax from property owner. County keeps the penalties/interest on late payments). Special tax rates charged to property owners are not affected by Teeter. The CFDs allow for accelerated foreclosure of one year, if special tax is not paid by property owner. The current Aggregate Outstanding Debt for Teeter as of June 30, 2013 is \$43,486,000.

SCOPE AND METHODOLOGY

Our audit covered the period July 1, 2012 through June 30, 2013, for Community Facilities Districts/Mello-Roos and included:

1. Evaluating CEO/PF and CEO/PF Accounting's internal controls and process regarding the community facilities districts/Mello-Roos process to ensure special tax levies were calculated in accordance with bond governing documents (i.e., Official Statements, Supplement to Bond's Resolutions, Acquisition, Funding and Disclosure Agreements, etc.).
2. Evaluating internal controls in CEO/PF and CEO/PF Accounting to ensure the bond's debt service and construction funds' disbursements are accurate, valid, adequately supported, and comply with the bond's governing documents, CEO/PF, CEO/PFA, and County policies and procedures. We designed our audit to assess disbursement approval controls, including segregation of duties, invoice tracking, supervisory/management approvals, ensuring compliance with contract terms, payment processing timeframes, and completeness and accuracy in processing disbursements.
3. Evaluating recent tax collections verification performed to ensure special taxes levied are collected (including Teeter) and accurately recorded to the appropriate CFD.
4. Evaluating the efficiency and effectiveness of the community facilities districts/Mello-Roos process, such as instances of backlogs, duplication of work, manual processes that could benefit from automation, and utilization of CAPS+ for processing of disbursements.

SCOPE EXCLUSIONS

Our audit scope did not include the controls, policies and processes in CEO/Public Finance's bond financing process or information technology or system controls. In addition, the controls over the CFDs/Mello-Roos were not audited in respect to the processes performed by the Assessor, Treasurer-Tax Collector, OC Public Works, or the Auditor-Controller Property Tax Unit, except for verifying that individuals designated as "authorized signers" in those areas were properly authorized on the County's Access Request Forms to approve payments.

Management's Responsibilities for Internal Controls

In accordance with the Auditor-Controller's County Accounting Manual section S-2 *Internal Control Systems*, "All County departments/agencies shall maintain effective internal control systems as an integral part of their management practices. This is because management has primary responsibility for establishing and maintaining the internal control system. All levels of management must be involved in assessing and strengthening internal controls..." Control systems shall be continuously evaluated (by Management) and weaknesses, when detected, must be promptly corrected. The criteria for evaluating an entity's internal control structure is the Committee of Sponsoring Organizations (COSO) control framework. Our Financial and Mandated Audit enhances and complements, but does not substitute for CEO/PF's and CEO/PFA's continuing emphasis on control activities and self-assessment of control risks.



Inherent Limitations in Any System of Internal Control

Because of inherent limitations in any system of internal controls, errors or irregularities may nevertheless occur and not be detected. Specific examples of limitations include, but are not limited to, resource constraints, unintentional errors, management override, circumvention by collusion, and poor judgment. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or the degree of compliance with the procedures may deteriorate. Accordingly, our audit would not necessarily disclose all weaknesses in CEO/PF's and CEO/PFA's operating procedures, accounting practices, and compliance with County policy.

Acknowledgment

We appreciate the courtesy extended to us by CEO/Public Finance and CEO/Public Finance Accounting during our audit. If we can be of further assistance, please contact me directly or Alan Marcum, Senior Audit Manager at 834-4119.

Attachments

Distribution Pursuant to Audit Oversight Committee Procedure No. 1:

Members, Board of Supervisors
Members, Audit Oversight Committee
Mark Denny, Chief Operating Officer
Frank Kim, Chief Financial Officer
Suzanne Luster, Director, CEO/Public Finance
Denise Steckler, Chief Deputy Auditor-Controller
Tonya Burnett, Director, Satellite Accounting Operations, Auditor-Controller
Claire Moynihan, Manager, CEO/Public Finance Accounting
Foreperson, Grand Jury
Susan Novak, Clerk of the Board of Supervisors
Macias Gini & O'Connell LLP, County External Auditor

Detailed Results, Findings, Recommendations and Management Responses



Objective #1: Special tax rates are calculated in accordance with pertinent governing documentation.

AUDIT STEPS AND RESULTS

To accomplish this objective, we audited internal controls over CEO/PF and CEO/PF Accounting's Community Facilities Districts/Mello-Roos special tax levy process. We performed the following audit steps:

- ✓ Held meetings and conducted walkthroughs of the Community Facilities Districts/Mello-Roos process and controls with CEO/PF and CEO/PFA staff and management responsible for processing the annual special tax levies.
- ✓ Evaluated the adequacy of CEO/PF and CEO/PF Accounting's Community Facilities Districts/Mello-Roos special tax levy written policies and procedures.
- ✓ Evaluated segregation of duties of CEO/PF and CEO/PFA management who hold delegated authority to approve special tax levies to ensure they do not have other incompatible duties.
- ✓ Evaluated internal controls by testing the annual special tax levy for a sample of **two (2) CFDs with the largest assets for FY 12/13**. For the special tax levies selected, we verified the operating effectiveness of the following controls:
 1. The calculation included the Special Tax Requirement as the amount required in any fiscal year for the CFD to pay the sum of:
 - I. debt service on all outstanding bonds;
 - II. periodic costs on the Bonds, including but not limited to, credit enhancement and rebate payments on the Bonds;
 - III. reasonable Administrative Expenses;
 - IV. any amounts required to establish or replenish any reserve funds for all outstanding bonds; and
 - V. any amount required for construction of facilities eligible under the Act. Amounts deposited on the debt service fund will be depleted at least once a year except for a reasonable carryover amount, which in the aggregate will not exceed the greater of one year's interest earnings on such funds for the previous fiscal year or one-twelfth of the annual debt service with respect to the obligations for the immediately preceding fiscal year.
 2. The calculation includes a reasonable carryover to determine if the accumulated carryover for the annual special tax levy for its CFDs to ensure they are in compliance with the Tax Certificates to ensure the debt service funds will be depleted at least once a year except for a reasonable carryover amount, if any, which in the aggregate, will not exceed the greater of:
 - One year's earnings on such funds for the immediately preceding bond year, or One-twelfth of the annual debt service with respect to the Obligations for the immediately preceding bond year.
 3. Special tax levy calculations were approved by authorized personnel.
 4. Selected parcel's maximum special annual tax is calculated accurately and agrees to the bonds corresponding Rate and Method of Apportionment Tables.
 5. Selected parcel's annual special tax was properly levied and agreed to the taxpayer's property tax bills.

Detailed Results, Findings, Recommendations and Management Responses



CONCLUSION

Our audit of internal controls and processes and our testing of the two (2) CFD special tax levies disclosed no exceptions, except for an issue regarding estimating administrative costs, indicating controls are in place to ensure special tax rates are calculated in accordance with pertinent governing documentation. We identified **one (1) Control Finding** regarding estimating administrative costs in the special tax levy calculation utilizing available historical data. The finding is discussed below:

Finding No. 1 – Estimating Administrative Costs (Control Finding)

Summary

Our testing disclosed for the most recent annual special tax levy calculation, FY 12/13 actual administrative expense information was available and therefore, should have been used as the basis for the FY 13/14 estimate of administrative costs.

Details

CEO/PF Accounting estimated administrative expenses based on FY 11/12 actual historical financial data. However, we noted that FY 12/13 actual administrative expense information was available and therefore, should have been used as the basis for the FY 13/14 estimate.

The CFDs Rate and Method of Apportionment of Special Tax Requirements defines the special tax as the amount required in any fiscal year for the CFD to pay the sum of: (i) debt service on all outstanding bonds; (ii) periodic costs on the Bonds, including but not limited to, credit enhancement and rebate payments on the Bonds; (iii) reasonable Administrative Expenses; (iv) any amounts required to establish or replenish any reserve funds for all outstanding bonds; and (v) any amount required for construction of facilities eligible under the Act. In arriving at the Special Tax Requirement, the CFD Administrator shall take into account the reasonably anticipated delinquent Special Taxes based on the delinquency rate for Special Taxes levied in the previous Fiscal Year and shall give a credit for funds available to reduce the annual Special Tax levy.

The requirements also define Administrative Expenses within the CFDs as actual or reasonably estimated costs directly related to the administration of a CFD.

Recommendation No. 1

We recommend CEO/Public Finance Accounting calculate the Special Tax Requirement in accordance with the Rate and Method of Apportionment by consistently and reasonably applying actual administrative expenses or reasonable estimates based on the most recently available data.

CEO/Public Finance Accounting Management Response:

Concur. When the current year tax setting project begins in June and worksheets are being prepared, the current year administrative costs are not finalized. Therefore, the prior year administrative expenses are used when calculating the tax rates. When the worksheets are completed and ready to be submitted to the tax consultant, the actual current year administrative expenses are normally available. We will compare the prior year administrative expenses to the current year administrative expenses for each CFD. If the variance is greater than or equal to 15%, then the tax rate calculation for that CFD will be updated to reflect the most recent year administrative expenses.

Detailed Results, Findings, Recommendations and Management Responses



Objective #2: Bond proceeds are used for projects in compliance with pertinent governing documentation.

AUDIT STEPS AND RESULTS

To accomplish this objective, we audited internal controls over CEO/PF and CEO/PF Accounting's Community Facilities Districts/Mello-Roos process. We performed the following audit steps:

- ✓ Held meetings and conducted walkthroughs of the Community Facilities Districts/Mello-Roos process and controls with CEO/PF and CEO/PFA staff and management responsible for processing the bond proceeds.
- ✓ Evaluated the adequacy of CEO/PF and CEO/PF Accounting's Community Facilities Districts/Mello-Roos written policies and procedures.
- ✓ Evaluated segregation of duties of CEO/PF and CEO/PFA management who hold delegated authority to approve bond proceeds' disbursements to ensure they do not have other incompatible duties.
- ✓ Evaluated internal controls by testing a judgmentally selected sample of **40 disbursements totaling \$37.6M**. For the disbursements selected, we verified the operating effectiveness of the following controls:
 1. Invoice/payment request contained proper date, identification and contract number and was mathematically correct.
 2. Payment was dated subsequent to services/work completed and disbursement authorization.
 3. Invoice was in accordance with the terms of the corresponding contract/agreement (i.e. work performed, contract period, and rates charged).
 4. Proper authorization was documented in writing by only authorized signers as designed on CAPS+ Access Request Forms at the time payment was approved.
 5. Debt service payments, if applicable, were in accordance with the terms of the debt service schedule as stated in the Bond's Official Statement.
 6. Invoice, if applicable, was charged to the proper line item in accordance with the Acquisition, Funding and Disclosure Agreement.
 7. Duties for authorizing purchasing (requisition), receiving (receipt of goods/services), and payment documents (invoice/request for payment) are not overlapping.
 8. Cost, if applicable, was for formation of the District, the costs of issuance of bonds under the proceedings and/or for the acquisition and/or construction of certain public facilities, including bridges, pedestrian bridges and tunnels, roadways, parks, regional hiking and biking trails, storm drains, traffic signals, water facilities, fire stations and equipment, sheriff's substations and equipment and library facilities and equipment, and all related appurtenant work (including utility line relocations and electric, gas and cable utilities) the "Facilities" upon land, or which will benefit land, within the District.
 9. If payment was to a Developer, the Final Acquisition Report documents the District Engineer's authorization for payment in accordance with the AFDA.
 10. Invoices were processed completely and accurately in CAPS+.
 11. Amounts recorded on the Subsidiary Records (Statement of Sources and Project Cost Reports) and/or General Ledger agrees with amount on the invoice or other supporting document.
- ✓ Evaluated the most recent tax collections verification performed to ensure special taxes levied are collected (including Teeter) and accurately recorded to the appropriate CFD.



CONCLUSION

Our audit of internal controls and processes and our testing of the bond proceeds indicate controls are in place to ensure bond proceeds are utilized in accordance with pertinent governing documentation, except for an issue regarding monitoring project costs. We identified **one (1) Control Finding** regarding monitoring project costs in accordance with the Acquisition, Funding and Disclosure Agreement. The finding is discussed below:

Finding No. 2 – Monitoring Project Costs (Control Finding)

Summary

Internal controls over monitoring project costs could be strengthened:

1. CFD's Project Cost Reports and Statement of Sources and Uses are not complete and up-to-date.
2. We noted costs are not consistently applied to Project Cost Reports.
3. Reconciliations between the Statement of Sources and Uses and the Project Cost Reports are not performed.

Details

CFD's Project Cost Reports and Statement of Sources and Uses are not complete and up-to-date. Project Cost Reports and Statement of Sources and Uses are used for monitoring project costs to ensure that they stay within the allowable cost categories as stated in the Acquisition, Funding and Disclosure Agreement (AFDA) and for monitoring cash available in the Bond's Acquisition and Construction Fund. The Statement of Sources and Uses is used to account for the uses of available cash. Nine (9) out of the sixteen (16) Project Cost Reports and Statement of Sources and Uses for the Acquisition and Construction Funds are not up-to-date as of June 30, 2013. Only the Ladera Ranch and Aliso Viejo CFD's Project Cost Reports and Statement of Sources and Uses have been completed as of June 30, 2013.

In addition, we noted costs are not consistently applied to Project Cost Reports. We noted that Countywide Cost Allocation CWCAP charges were included in the cost reports charged against specific AFDA line items in earlier bond years; however, we noted FY 12/13 CWCAP were excluded.

Furthermore, we noted reconciliations between the Statement of Sources and Uses and the Project Cost Reports are not performed to ensure all project costs that should have been recorded were recorded correctly.

The County of Orange Accounting Manual, Number S-2, Section 3.3, Authorization, Execution, and Recording of Transactions, states as follows: "A system of authorization and record-keeping procedures is needed to provide effective accounting control over assets, liabilities, revenues, and expenditures. Independent evidence shall be maintained to document that authorizations are issued by persons acting within the scope of their authority and that transactions conform with the terms of the authorizations. Documentation shall provide an adequate audit trail. Transactions shall be accurate, timely, properly recorded, and properly classified. Computer system controls should be utilized to safeguard records and preserve data integrity."

There is a risk of project costs exceed the allowable cost categories as stated in the AFDAs. In addition, there is a risk that cash may not be available to complete the required projects as stated in the AFDAs.

Detailed Results, Findings, Recommendations and Management Responses



Recommendation No. 2

We recommend CEO/Public Finance Accounting develop procedures to ensure Project Cost Reports and Statement of Sources and Uses Reports are prepared timely and reflect an accurate accounting of remaining available cash balances. In addition, we recommend CEO/PFA complete a reconciliation between the Project Cost Reports and Statement of Sources and Uses to the General Ledger on a regular basis to ensure all project costs (including those costs not directly charged against a specific cost category) are properly recorded.

CEO/Public Finance Accounting Management Response:

Concur.

1. Due to unforeseen staffing resource issues, tasks in the unit during the months of June through September had to be prioritized. Tasks were prioritized based on the criticalness of the project and meeting important deadlines. Based on that analysis, it was determined that debt service payments were the highest priority. The Sources and Uses reports, which if used are only used on an annual basis were determined to be a low priority and were not updated timely. The unit is now fully staffed and the Sources and Uses reports will be completed in a timely manner. The active Project Costs schedules were updated through fiscal year end but due to the staffing resources, were determined to be a low priority due to a slowdown in construction activity. These schedules are now being updated in a timely manner.
2. CWCAP charges should not be assigned to specific projects but should be noted separately on a consistent manner.
3. While both the Statement of Sources and Uses and the Project Cost Reports are reconciled to the General Ledger, cross referencing the two reports to each other would strengthen controls. This will be done for the one remaining district (CFD 2004-01) that will still have active construction projects after this fall.

Objective #3: Determine if the process is efficient and effective (e.g., no backlogs, duplication of work, manual processes that can be automated).

AUDIT STEPS AND RESULTS

To accomplish this objective, we used auditor inquiry and observation to determine if CEO/PF and CEO/PF Accounting's Community Facilities Districts' processes were efficient and effective. We also:

- ✓ Held meetings, conducted walkthroughs, and made auditor observations and inquiries of the community facilities districts/Mello-Roos process with CEO/PF and CEO/PF Accounting.
- ✓ Evaluated CEO/PF and CEO/PF Accounting policies/procedures for processing community facilities districts' bond proceeds.
- ✓ Performed testing on a sample of debt and construction funds' disbursements to determine the effectiveness of disbursement approval processes and controls.

CONCLUSION

We did not note any instances of duplication of work or manual processes that could be automated in community facilities districts processes.

As a result, we have no recommendations for this objective.



ATTACHMENT A: Report Item Classifications

For purposes of reporting our audit observations and recommendations, we will classify audit report items into three distinct categories:

▶ **Critical Control Weaknesses:**

Serious audit findings or a combination of Significant Control Weaknesses that represent critical exceptions to the audit objective(s) and/or business goals. Management is expected to address Critical Control Weaknesses brought to their attention immediately.

▶ **Significant Control Weaknesses:**

Audit findings or a combination of Control Findings that represent a significant deficiency in the design or operation of internal controls. Significant Control Weaknesses generally will require prompt corrective actions.

▶ **Control Findings:**

Audit findings concerning internal controls, compliance issues, or efficiency/effectiveness issues that require management's corrective action to implement or enhance processes and internal controls. Control Findings are expected to be addressed within our follow-up process of six months, but no later than twelve months.



ATTACHMENT B: CEO/Public Finance Accounting Management Response



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PROPERTY TAX

VICTORIA ROSS, CPA
DIRECTOR
CENTRAL ACCOUNTING OPERATIONS

December 19, 2013

TO: Peter Hughes, Director
Internal Audit Department

SUBJECT: Response to Community Facilities Districts Audit No. 1317

We reviewed the draft audit report dated October 25, 2013, prepared by the Internal Audit Department, covering the audit of Community Facilities Districts for the period ending June 30, 2013.

Our responses to the recommendations made in the draft audit report that relate to Public Finance Accounting are attached.

Please call Claire Moynihan, Public Finance Accounting Manager at 834-5969 if you have any questions regarding our responses.

Thank you.

Jan Grimes
Auditor-Controller

Attachment

cc: Mike B. Giancola, County Executive Officer
Frank Kim, Chief Financial Officer
Denise Steckler, Chief Deputy, Auditor-Controller
Tonya Bumett, Director of Satellite Accounting Operations, Auditor-Controller
Suzanne Luster, CEO/Public Finance Manager
Claire Moynihan, Manager, CEO/Public Finance Accounting

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ATTACHMENT B: CEO/Public Finance Accounting Management Response

Recommendation No. 1

We recommend CEO/Public Finance Accounting calculate the Special Tax Requirement in accordance with the Rate and Method of Apportionment by consistently and reasonably applying actual administrative expenses or reasonable estimates based on the most recently available data.

CEO/Public Finance Accounting Management Response:

Concur. When the current year tax setting project begins in June and worksheets are being prepared, the current year administrative costs are not finalized. Therefore, the prior year administrative expenses are used when calculating the tax rates. When the worksheets are completed and ready to be submitted to the tax consultant, the actual current year administrative expenses are normally available. We will compare the prior year administrative expenses to the current year administrative expenses for each CFD. If the variance is greater than or equal to 15%, then the tax rate calculation for that CFD will be updated to reflect the most recent year administrative expenses.

Recommendation No. 2

We recommend CEO/Public Finance Accounting develop procedures to ensure Project Cost Reports and Statement of Sources and Uses Reports are prepared timely and reflect an accurate accounting of remaining available cash balances. In addition, we recommend CEO/PFA complete a reconciliation between the Project Cost Reports and Statement of Sources and Uses to the general ledger on a regular basis to ensure all project costs (including those costs not directly charged against a specific cost category) are recorded and recorded correctly.

CEO/Public Finance Accounting Management Response:

Concur.

1. Due to unforeseen staffing resource issues, tasks in the unit during the months of June through September had to be prioritized. Tasks were prioritized based on the criticalness of the project and meeting important deadlines. Based on that analysis, it was determined that debt service payments were the highest priority. The Sources and Uses reports, which if used are only used on an annual basis were determined to be a low priority and were not updated timely. The unit is now fully staffed and the Sources and Uses reports will be completed in a timely manner. The active Project Costs schedules were updated through fiscal year end but due to the staffing resources, were determined to be a low priority due to a slowdown in construction activity. These schedules are now being updated in a timely manner.



ATTACHMENT B: CEO/Public Finance Accounting Management Response

2. CWCAP charges should not be assigned to specific projects but should be noted separately on a consistent manner.
3. While both the Statement of Sources and Uses and the Project Cost Reports are reconciled to the General Ledger, cross referencing the two reports to each other would strengthen controls. This will be done for the one remaining district (CFD 2004-01) that will still have active construction projects after this fall.