AGENDA ITEM 18
November 17, 2009
Public Hearing

MEMORANDUM

TO: County Council

FROM: Robert H. Drummer, Senior Legislative Attorney

SUBJECT: **Public Hearing**: Expedited Bill 40-09, Personnel – Audits – Trust Funds

Expedited Bill 40-09, Personnel – Audits – Trust Funds, sponsored by Council President Andrews was introduced on November 10. The Management and Fiscal Policy Committee, meeting as the Audit Committee, reviewed this Bill on November 10, 2009 at 12:15 p.m. A second worksession before the Committee is scheduled for November 24 at 12:15 p.m.

Background

Section 315 of the Charter requires that:

> The Council shall contract with, or otherwise employ, a certified public accountant to make annually an independent post audit of all financial records and actions of the County, its officials and employees. The complete report of the audit shall be presented to the Council and copies of it shall be made available to the public.

County Code §33-51 requires the Council to retain a firm of certified public accountants to conduct an annual independent audit of the Employee's Retirement System (ERS). Code §33-122(g) similarly requires an annual independent audit of the Retirement Savings Plan (RSP). However, there is no equivalent provision requiring annual independent audits of the County deferred compensation plan, the collectively bargained deferred compensation plan,[1] or the Retiree Health Benefits Trust Fund.

Expedited Bill 40-09 would, pursuant to Charter §315, require an annual independent audit of each deferred compensation plan and the Retiree Health Benefits Trust Fund. The Council would hire the audit firm and the audit report would be filed with the Council and made available for public inspection.

[1] IRS rules require that the collectively bargained plan be "established and maintained by the County" in order to be considered a government sponsored plan.

Issues

1. What independent audits of County trust funds are currently being done?

The Council's Management and Fiscal Policy Committee (MFP) issued a Request for Proposals in 2007 to retain a firm of certified public accountants to conduct independent audits of the basic financial statements of the County government, the ERS, and the RSP. The MFP Committee evaluated the proposals and recommended the award to Clifton Gunderson LLP (Clifton). The Council approved the contract with Clifton in Resolution 16-501 on March 8, 2008. The contract is currently managed by the Office of Legislative Oversight.

Clifton is currently working on the independent audit of the County government financial statements for FY09 and an audit of the County's ERS[2] and RSP. Although the legislation creating the Retiree Health Benefits Trust in 2008 does not include a required independent audit, Clifton is reviewing the FY09 financial statement for this Trust Fund as part of the County government audit. Clifton is also auditing the FY09 financial statements for the County's deferred compensation plan as part of the audit of the County's retirement systems. The current scope of services for Clifton does not include an independent audit of the collectively bargained deferred compensation plan. The Bill would require the Council to hire a firm to conduct an independent audit of the collectively bargained plan and require the audits of the County deferred compensation plan and the Retiree Health Benefits Trust Fund that are already being done by Clifton.

2. Does the County audit the financial records of the Revenue Authority, the Maryland National Capital Park and Planning Commission (M-NCPPC), the Washington Suburban Sanitary Commission (WSSC), the Montgomery County Board of Education (BOE), or Montgomery College?

The Montgomery County Revenue Authority is an instrumentality of the County and a public corporation. County Code §42-24(b) requires the Authority to hire a certified public accountant to annually audit its financial statements and provide a copy to the Executive. If the Authority fails to have the audit done, the Executive is authorized to do it. The M-NCPPC, WSSC, BOE, and Montgomery College are all agencies of the State of Maryland created by State law. The State laws creating each of these agencies requires them to hire a firm to annually conduct an independent audit of their financial records and provide a copy to the County. See, Md. Code, Art. 28, §2-113 (M-NCPPC), Md. Code, Art. 29 §1-106 (WSSC), Md. Code, Education Art. §16-315 (Montgomery College), Md. Code, Education Art. §5-109 (BOE).

3. Does Charter §315 require the Council to hire a firm to audit the collectively bargained deferred compensation plan?

The collectively bargained deferred compensation plan (Union Plan) was authorized by Bill 35-04, now codified as Code §33-146B. The plan is established as a government sponsored deferred compensation plan pursuant to §457(b) of the Internal Revenue Code. IRS Rev. Rul. 2004-57 first authorized a union to offer a government sponsored deferred compensation plan to

[2] The Guaranteed Retirement Income Plan did not begin until FY10, but it is part of the ERS.

its members who are government employees under §457(b) if the government employer has agreed to "establish and maintain" the plan.

The County retained outside counsel, the Groom Law Group, for legal advise on how to comply with these IRS rules in establishing the Union Plan during the consideration of Bill 35-04. The Groom Law Group advised that the County retains ultimate fiduciary responsibility for the plan even after delegating fiduciary and administrative responsibility to union officials. Bill 35-04 required the union to obtain fiduciary liability insurance protecting itself and the County and indemnify the County from liability. See §33-146B(c). Although these provisions may protect the County from financial loss, they do not eliminate the fiduciary responsibility.

The County's fiduciary responsibility to its employees participating in the Union Plan requires it to oversee the actions of its delegated union fiduciaries. The Charter §315 audit requirement is consistent with this oversight fiduciary responsibility. However, the operative language of Charter §315 requires the Council to "contract with, or otherwise employ" a firm of certified public accountants. The Council can satisfy this requirement by hiring the auditor itself or by ensuring that the union hires an independent auditor and provides a timely copy to the Council.[3]

For all these reasons, it is the opinion of Council staff that Charter §315 requires the Council to ensure that an independent audit of the Union Plan is conducted annually and a copy of the report is provided to the Council and made available for public inspection.

4. Must the County include the Union Plan's financial statements as part of its Comprehensive Annual Financial Report (CAFR) if it hires a firm to audit the Union Plan?

The hiring of a firm of certified public accountants to audit the financial statements of the Union Plan would not change the County's fiduciary responsibility to its employees who participate. The union would retain fiduciary and administrative responsibility for the Union Plan. Council staff reviewed this issue with the Office of Legislative Oversight, the County Office of Finance, and the County's current auditor, Clifton. Council staff received an informal opinion from Clifton that Bill 40-09 would not require the County to include the financial statements of the Union Plan in its CAFR under the relevant Governmental Accounting Standards Board Regulations.

5. What is the cost to hire a firm to audit the Union Plan?

The Council could hire a firm by either expanding the scope of services in Clifton's contract or hire a firm under a new contract solicitation. A rough estimate for adding this work to the Clifton contract is $20,000 to $25,000. The actual cost would depend upon negotiations with Clifton and the scope of the audit requested. The cost to hire a new firm should be similar, but the actual cost would depend upon the scope of work and the competition for the work.

[3] The union has not routinely provided copies of annual audit reports to the Council since the Union Plan was established in 2005. Council staff requested and recently received a copy of the Union Plan's independent audit report for calendar year 2007, dated October 13, 2009. Council staff was informed that the auditor was close to completing the audit for calendar year 2008.

Council staff recommendation: Subject to the public hearing testimony, enact the Bill as introduced. The Council can best ensure that the independent audit of the Union Plan is consistent with the audits of other trust funds by hiring the auditor. However, if the Committee wants to delegate this function to the union, the Bill should be amended to require the union to hire a firm to conduct an annual audit in a timely manner and provide copies of the report and the letters on internal control to the Council.

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MEMORANDUM

November 5, 2009

TO: Councilmembers

FROM: Phil Andrews, Council President

SUBJECT: Annual Independent Audit of the Retiree Health Benefits Trust and Deferred Compensation Plans

Charter §315 requires the Council to retain "a certified public accountant to make annually an independent post audit of all financial records and actions of the County, its officials and employees. The complete report of the audit shall be presented to the Council and copies of it shall be made available to the public."

To comply with Charter §315, County Code §33-51 and §33-122(g) require the Council to retain a firm of certified public accountants to conduct an annual independent audit of the County's retirement plans. The audit report must be made available for public inspection.

There is no equivalent provision requiring an annual independent audit of the Retiree Health Benefits Trust, the County deferred compensation plan, or the collectively bargained deferred compensation plan. IRS rules require that the collectively bargained plan be "established and maintained by the County" in order to be considered a government sponsored plan.

To comply with Charter §315, the attached bill, which is scheduled for introduction on November 10, would add a new requirement for an annual independent audit, conducted by a firm of certified public accountants retained by the Council, of the Retiree Health Benefits Trust and each of the County's deferred compensation plans. The importance of this requirement, from the standpoint of good government and sound financial management, is clear from the attached October 20 *Baltimore Sun* account of the results of an audit of one of the State's deferred compensation plans.

I welcome your co-sponsorship of this bill.

Attachment

Expedited Bill No. 40-09
Concerning: Personnel – Audits – Trust Funds
Revised: November 4, 2009 Draft No. 11
Introduced: November 10, 2009
Expires: May 10, 2011
Enacted: ______
Executive: ______
Effective: ______
Sunset Date: None
Ch. _____, Laws of Mont. Co. ______

COUNTY COUNCIL
FOR MONTGOMERY COUNTY, MARYLAND

By: Council President Andrews

AN EXPEDITED ACT to:
(1) require an annual independent audit of each deferred compensation plan;
(2) require an annual independent audit of the Retiree Health Benefits Trust; and
(2) generally amend the law concerning audits of County trust funds.

By adding
Montgomery County Code
Chapter 33, Personnel and Human Resources
Article IX. Deferred Compensation Plan.
Section 33-146C

By amending
Montgomery County Code
Chapter 33, Personnel and Human Resources
Article XI. Other Post Employment Benefits Trust
Section 33-162

Boldface	*Heading or defined term.*
Underlining	*Added to existing law by original bill.*
[Single boldface brackets**]**	*Deleted from existing law by original bill.*
Double underlining	*Added by amendment.*
[[Double boldface brackets**]]**	*Deleted from existing law or the bill by amendment.*
* * *	*Existing law unaffected by bill.*

The County Council for Montgomery County, Maryland approves the following Act:

Sec. 1. Section 33-146C is added and Section 33-162 is amended as follows:

33-146C. *Independent audit.*

To comply with Section 315 of the County Charter, a firm of certified public accountants, under contract with the Council, must complete an annual independent audit of the County Plan and each Collectively Bargained Plan established and maintained by the County. The complete audit must be filed with the Council, and copies made available for public inspection.

33-162. Trust Fund management.

(a) General. The Board has the exclusive authority to manage the Trust Fund's assets. All powers and duties required to manage the Trust Fund are vested in the Board by this Article.

* * *

(j) To comply with Section 315 of the County Charter, a firm of certified public accountants, under contract with the Council, must complete an annual independent audit of the Trust Fund. The complete audit must be filed with the Council, and copies made available for public inspection.

Sec. 2. Expedited Effective Date.

The Council declares that this legislation is necessary for the immediate protection of the public interest. This Act takes effect on the date it becomes law.

Approved:

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Philip M. Andrews, President, County Council Date

baltimoresun.com

Pension agency failed to disclose loss, auditors say

Report criticizes state staff, board's oversight

By Michael Dresser | michael.dresser@baltsun.com

October 20, 2009

The agency that runs a voluntary retirement plan for state employees failed to adequately disclose a $48 million loss in the market value of a conservative investment pool, according to an audit released Monday.

A toughly worded report suggests that the staff and board of the Maryland Teachers and State Employees Supplemental Retirement Plans had been lax in their oversight of private firms that manage many of the plan's investments. The auditors also said plan managers were unable to answer many of their questions or provide relevant documents.

The issues raised by legislative auditors echo many of the concerns surrounding the much larger Maryland state retirement fund several years ago, when the state pension board and staff failed for many months to detect an investment fraud that cost the system millions of dollars. Those problems led to the conviction in federal court of money manager Nathan A. Chapman Jr.

In the case of the supplemental system, the auditors did not suggest criminal activity and made no referral to law enforcement agencies. But the tone of their criticism raised hackles among board members.

"The language, candidly, in the analysis was somewhat inflammatory," said state Treasurer Nancy K. Kopp, a board member.

The supplemental system, which closed the year with $1.9 billion in assets but which has grown to $2.2 billion, is a deferred-compensation program in which state employees and public school teachers can voluntarily invest part of their income in a tax-sheltered plan.

Michael T. Halpin, executive director of the supplemental plan, said none of the 27,163 investors in the fund in question lost money as a result of the matters raised by the auditors. He said his agency has made many changes in response to the report's recommendations.

"This is a really important issue and it's really important that people not be scared away from something that is working well," Halpin said.

The plan is overseen by a nine-member board appointed by the governor and chaired by

Secretary of Budget and Management T. Eloise Foster.

Foster, who served on the larger pension board when the Chapman scandal was unfolding, said she sees no parallels between that system then and the supplemental system now.

How audit began

The special audit, prompted by an allegation made through a "fraud, waste and abuse" hot line, focused on a period last year when many retirement plans were slipping amid the mortgage meltdown, credit crunch and banking collapse.

The auditors focused on one fund within the supplemental system's group of plans: the Investment Contract Pool. The plan was intended to be the most conservative option, similar to a money market fund within a 401(k) plan. The fund is intended to guard the safety of the investor's money and is "perceived by participants as the investment equivalent of a retirement 'security blanket,' " the auditors said.

Nevertheless, at the end of last year, the fund's unrealized losses had opened up a $48 million gap between the $729 million book value of its investments and its $681 million market value.

According to the auditors, the supplemental retirement plan did not disclose market losses to its participants until September 2008. As a result, they said, "the ability of existing and prospective plan participants to make informed investment decisions using basic and critical financial information was significantly impaired."

Halpin said that before last fall's changes, the plan had reported the book value of participants' assets. He said that for the first 27 years after the plans were created in 1985, there was little difference between market and book value to report.

Auditors vs. board

The auditors said that after the investigation was launched, the agency decided to disclose the percentage difference between book value and market value. However, they contend the plan should also disclose the dollar amount of that difference - a stance with which the board disagrees.

Halpin said that as of the end of last month, the conservative fund had recovered sufficiently to post a market value of $734.2 million, or 98.4 percent of its book value of $745.8 million. At its worst last October, the market value stood at only 92 percent of book value.

Auditors said they questioned how the supplemental plan could pay fund participants a relatively generous 4.4 percent interest rate during the last quarter of 2008 despite its market losses. They said the board has since reset the payout to 3.5 percent and begun to recalculate it monthly.

Hiring questions

The report also criticized the plan for its oversight of sub-managers hired by its investment manager, Deutsche Bank AG. That issue also arose in the state's earlier pension scandal, when the state pension board delegated to Chapman the oversight of a sub-manager who subsequently defrauded the fund and invested money in a company controlled by Chapman - resulting in a loss to the state when that company tanked.

In the case of the supplemental fund, the auditors said the plan's managers could not provide substantive documentation to show that it had taken steps to address the performance of two lagging sub-managers. The auditors suggested the board allowed sub-managers to stray too far from the benchmarks for their industry sector - giving the example of one that was heavily invested in mortgage-backed securities and light on low-risk government bonds at a time when many mortgages were being exposed as "toxic assets."

In a vigorous 16-page response, the supplemental plan defended its oversight of its investment managers and called the auditors' criticism of their returns as "speculative with the benefit of hindsight."

But Kopp, while defending the board's oversight of its money managers, admitted the staff's documentation of such efforts needs to improve.

"In retrospect, we wish the minutes had been more detailed," she said.

Foster said the board's response to the auditors was "very thorough."

Shaun Adamec, a spokesman for Gov. Martin O'Malley, said Foster would make sure that any problems are corrected.

"The governor certainly has confidence in her abilities and her ability to recognize the issues raised in the report and to respond to them," Adamec said.

LEGISLATIVE REQUEST REPORT

Expedited Bill 40-09
Personnel – Audits – Trust Funds

DESCRIPTION:	To require an annual independent audit of each deferred compensation plan and the Retiree Health Benefits Trust Fund.
PROBLEM:	Charter §315 requires the Council to hire or otherwise employ a firm of certified public accountants to conduct an annual independent audit of all County financial records and actions. Current law requires this audit for the retirement plans, but does not require a similar audit of the deferred compensation plans and the Retiree Health Benefits Trust Fund.
GOALS AND OBJECTIVES:	To amend the law to comply with Charter §315.
COORDINATION:	Office of Human Resources, Board of Investment Trustees, Office of Legislative Oversight, Department of Finance
FISCAL IMPACT:	To be requested.
ECONOMIC IMPACT:	To be requested.
EVALUATION:	To be requested.
EXPERIENCE ELSEWHERE:	To be researched.
SOURCE OF INFORMATION:	Robert H. Drummer, Legislative Attorney, 240-777-7895
APPLICATION WITHIN MUNICIPALITIES:	Not applicable.
PENALTIES:	None