Internal Audit Report

Bond Covenant

TxDOT Office of Internal Audit
Objective
Identify TxDOT’s obligations for monitoring bond covenants and determine if the controls are designed and operating effectively within TxDOT’s bond program.

Opinion
Based on the audit scope areas reviewed, control mechanisms are effective and substantially address risk factors and exposures considered significant relative to impacting financial reporting reliability, operational execution, and regulatory compliance. The organization’s system of internal controls provides reasonable assurance that most key goals and objectives will be achieved despite significant control gap corrections and improvement opportunities identified. Control gap corrections and improvement opportunities identified are likely to impact the achievement of the organization’s business/control objectives, but management has agreed to corrective action plans to address the relevant risks within 6 months.

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<thead>
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<th>Overall Engagement Assessment</th>
<th>Satisfactory</th>
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<td>Findings</td>
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<td>Title</td>
<td>Control Design</td>
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<td>Finding 1 Bond Covenant Monitoring Process</td>
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<td>Finding 2 Monitoring for Project Level Risk</td>
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<tr>
<td>Finding 3 Contract Required with Arbitrage Consultant</td>
<td>x</td>
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Management concurs with the above findings and prepared management action plans to address deficiencies.

Internal Environment
TxDOT’s Innovative Financing/Debt Management Office (IFDMO) and Finance (FIN) staffs recognize the risks inherent in the administration of TxDOT’s bond program. The impact to TxDOT’s core business and the costs associated with the bond program are significant. Management at TxDOT recognizes the function’s importance to the organization. Critical activities are performed by a few key individuals increasing the need for adequate procedures and succession planning.
Summary Results

<table>
<thead>
<tr>
<th>Finding</th>
<th>Scope Area</th>
<th>Evidence</th>
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<tr>
<td>1</td>
<td>Financial Data Analysis Specific Bond Monitoring &amp; Reporting; External Communication</td>
<td>Retention of the following documentation to support key activities is needed: 1. monitoring for binding contract targets (i.e. letting schedules used by IFDMO); 2. the process and support of the required IRS filings including arbitrage rebate analysis reports (i.e. timing, frequency, content, documentation and retention of transfer support); 3. monitoring for private use restrictions at a project level</td>
</tr>
<tr>
<td>2</td>
<td>Construction Cost; Financial Data Analysis Specific Bond Monitoring &amp; Reporting; External Communication</td>
<td>A consistent and effective process for monitoring spending limits on private use activities is needed. An opportunity exists to partner with the districts/division/administration for training and knowledge sharing on bond covenant requirements.</td>
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<tr>
<td>3</td>
<td>External Communication</td>
<td>A documented agreement with TxDOT’s arbitrage consultant is needed.</td>
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Audit Scope

The scope of the audit work focused on activities by the Innovative Financing/Debt Management Office (IFDMO) and Finance (FIN) organizations. Audit activities included tests to determine that post issuance bond monitoring is documented and considered effective to meet the requirements of rules, laws and regulations. Audit activities included review of documents provided by IFDMO, FIN and visits to 8 TxDOT Districts where 31 District projects were selected to review at the project level.

The audit was performed by Lindsay Bibeau, Albert ‘Terry’ Bourque, and Sonya Ayers, Engagement Lead. The audit was conducted during the period from June 10, 2013 to September 23, 2013.
Methodology
The work performed consisted of:

- review of specific bond covenant requirements from selected bond issues
- review of TxDOT’s Written Procedures for Post Bond Issuance Federal Tax Compliance
- review of TxDOT’s Debt Management Policy and other internal TxDOT policies and procedures (including document retention guidance)
- review of Securities Exchange Commission (SEC) Rule 15c2 – 12
- review of Internal Revenue Code 149(e) and other pertinent code references
- review of Government Accounting Standards (GASB) 54
- review of Texas Constitution Article III Section 49 & Texas Transportation Code Sections 201 & 222
- review of TxDOT’s Bond Evaluation Expenditure Report (BEER) procedures and guidelines for completion
- inquiry and interview of key personnel
- review of internal documents including organization charts and internal memos
- review of prior audit findings reports from TxDOT’s audit office
- evaluation of control design and operating effectiveness of the bond covenant monitoring and reporting process for TxDOT’s bond program

Tests were performed to assess the control design and effectiveness of data analysis, specific bond project monitoring and reporting (including construction cost expenditures) and external communication.

Background
This report was prepared for the Texas Transportation Commission, TxDOT’s Administration and Management. The report presents the results of the Bond Covenant Audit which was conducted as part of the Fiscal Year 2013 Audit Plan.

TxDOT’s bond program supports TxDOT’s core business by providing a critical funding source for activity related to right of way acquisition, public road construction, maintenance and monitoring of the state’s highway system.
TxDOT bond program covenants included in the review are outlined below:

<table>
<thead>
<tr>
<th>Bond Type</th>
<th>Authorized</th>
<th>Issued</th>
<th>Unissued</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highway Improvement General Obligation Financing Program (HIGO - Prop 12)</td>
<td>$5.0</td>
<td>$2.1</td>
<td>$2.9</td>
</tr>
<tr>
<td>State Highway Fund Revenue Financing Program (SHF - Prop 14)</td>
<td>$6.0</td>
<td>$4.6</td>
<td>$1.4</td>
</tr>
<tr>
<td>Texas Mobility Fund Revenue Financing Program (TMF)</td>
<td>$7.2</td>
<td>$6.0</td>
<td>$1.2</td>
</tr>
</tbody>
</table>

*Source: Semi-annual Issuer Reports As of 2/28/13
Table in Billions

IFDMO works with FIN to develop the necessary reporting and data analysis to ensure conformance with bond covenant requirements, laws and regulations. IFDMO’s responsibilities include other debt-related activities at TxDOT, including multiple debt programs, oversight of the State Infrastructure Bank and Pass-Through Tolling activities. IFDMO also makes recommendations on investment policy and portfolio management.

We conducted this performance audit in accordance with Generally Accepted Government Auditing Standards and in conformance with the International Standards for the Professional Practice of Internal Auditing. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

A defined set of control objectives was utilized to focus on financial, operational and regulatory goals for the identified scope areas. Our audit opinion is an assessment of the health of the overall control environment based on (1) the effectiveness of enterprise risk management activities throughout the audit period and (2) the degree to which the defined control objectives were being met. Our audit opinion is not a guarantee against financial misstatement, operational sub-optimization or regulatory non-compliance, particularly in areas not included in the scope of this audit.
Finding No. 1: **Bond Covenant Monitoring Process**

**Condition**
Documentation and execution of a sustainable process that addresses internal and external requirements to monitor for bond program covenants is needed. Information to support key activities should be retained by the Innovative Financing/Debt Management Office (IFDMO).

**Effect/Potential Impact**
Without a documented process for monitoring bond compliance, there is an increased risk of non-compliance with bond covenants, internal policies, and state and federal regulation which can result in:

- negative impacts to the tax advantaged status of the existing bond programs
- supporting documentation that does not substantiate compliance or is not readily available as required by Internal Revenue Code Section 1.6001-1(a).

**Criteria**
Internal Revenue Code Section 1.6001-1(a) outlines the requirements to retain data for all tax payers and the IRS’ Tax Exempt Bond Frequently Asked Questions addresses specific requirements for tax exempt bonds to include:

- data sufficient to substantiate compliance and support continued exclusion being taken
- sufficient records to show that all tax-exempt bond related returns are correct
- documentation evidencing expenditure of bond proceeds
- documentation evidencing use of bond-financed property by public or private sources
- information maintained within a system must be cross-referenced with the tax payer’s books and records in a manner that provides an audit trail to the source documents

In addition, IRC Section 1.148-5(d)(6)(iii)(E) states that the issuer is responsible for retaining data for 3 years after the last outstanding bond is redeemed or paid.

**Cause**
TxDOT’s “Written Procedures for Post Bond Issuance Federal Tax Compliance” assigns the duty to instruct monitoring for bond covenant compliance to IFDMO; however, specific assignments for monitoring activities have not been defined including content, frequency and reporting of results.

**Evidence**
Sufficient documentation was not available for review during the course of the audit:

1. monitoring for binding contract targets (i.e. letting schedules, or other means to be identified)
2. the process and support of the required IRS filings including arbitrage rebate analysis reports (i.e. timing, frequency, content, documentation and retention of transfer support)
3. monitoring for private use restrictions at a project level
Management Action Plan (MAP)

**MAP Owner:** Jennifer Wright, Financial Analyst, Innovative Financing/Debt Management Office

**MAP 1.1** – IFDMO will expand current procedures to include more detail for documenting performance of such procedures that are contained in the Commission’s “Written Procedures for Post Bond Issuance Federal Tax Compliance.” The additional detail could include information on frequency, content, source documents and personnel responsible and address the following activities:

- monitoring the commitment of proceeds through binding contracts and reporting to the appropriate district/division/office (DDO) staff
- monitoring the expenditure rate of proceeds and reporting to the appropriate DDO staff
- monitoring investment of proceeds
- computing excess investment earnings unless excepted from rebate and yield restrictions
- preparing and ensuring timely filing of tax or information returns such as IRS Forms 8038-G, 8038-CP, 8038-T, 8038-R, etc.
- monitoring for private business use for any facilities financed or refinanced with tax advantaged bond proceeds

**Completion Date:** July 15, 2014

**MAP 1.2** – IFDMO will collaborate with FIN to find ways to periodically monitor expenditures at the project/CSJ level to identify projects that may not be progressing as anticipated. If remedial action is deemed necessary, the appropriate DDO will be consulted to find a solution if necessary.

**Completion Date:** IFDMO will develop this process in conjunction with MAP 1.1 above and plans to have it finalized by July 15, 2014.

**MAP Owner:** Brian Ragland, Director Finance Division

**MAP 1.3** – Finance will establish key controls for cash reconciliations, such as evidence of supporting documentation and review as well as access and distribution restrictions

**Completion Date:** April 15, 2014
Finding No. 2: Monitoring for Project Level Risk

Condition
The process to monitor for project level risk needs improvement to identify:
- project level bond covenant restrictions, including, but not limited to, restrictions on expenditures for private use activities
- knowledge gaps or needed training to address knowledge gaps
- projects missing spend down targets

Effect/Potential Impact
Without monitoring at a project level, there is an increased risk of:
- reclassification of tax exempt/tax advantaged bonds to private activity bonds
- non-compliance with bond covenants, internal policies, state and federal regulation
- negative impacts to the tax exempt or tax advantaged status of the existing bond programs

Criteria
TxDOT’s "Written Procedures for Post Bond Issuance Federal Tax Compliance" outlines the requirements to preserve the tax-advantaged status of the bonds subsequent to bond issuance under the applicable revenue code and regulations.

The procedures include, but are not limited to, those regarding monitoring for private business use:
- monitor dates on which projects are substantially complete and available to be used for their intended purpose
- monitor whether, at any time during which the bonds are outstanding, any person other than the Commission, TxDOT’s employees or agents and members of the general public has any contractual right with respect to any portion of the facilities
- determine whether, at any time during which the bonds are outstanding, the facilities are sold or otherwise disposed of
- take such action as is necessary to remediate any failure to maintain compliance with the covenants contained in the resolutions or indentures authorizing issuance of bonds related to the public use of the facilities

Bond covenants state that TxDOT will ensure preservation of the tax exempt/tax advantaged status of the bonds. This includes preventing any actions that could result in exceeding ‘private activity bonds’ threshold noted within IRC section 141(b).

Cause
IFDMO monitors private use restriction risk at the portfolio level. Knowledge and training for division and district personnel in a position to detect bond covenant restrictions at the project level is limited.

Evidence
One bond series exceeded the threshold of $15 million allowed for private use in the revenue code. Finance made an adjustment to de-allocate funds and bring the potential for private use expenditures under the threshold amount.
Audit observed that an opportunity exists to partner with the DDOs for training and knowledge sharing on bond covenant requirements.

**Management Action Plan (MAP)**

**MAP Owner:** Jennifer Wright, Financial Analyst, Innovative Financing/Debt Management Office

**MAP 2.1** – IFDMO will collaborate with FIN, OGC and other DDOs to establish better controls including procedures for documenting the controls that will limit the use of tax exempt bond proceeds on projects for which there is a private use component.

**MAP 2.2** – IFDMO will work with administration to develop and implement a system (such as training manuals or procedures) to address knowledge gaps regarding the appropriate use of bond proceeds to ensure bond covenant compliance.

**Completion Date:** July 15, 2014
Finding No 3: Contract Required with Arbitrage Consultant

Condition
No documented agreement for arbitrage services performed by a third party for the Innovative Financing/Debt Management Office (IFDMO) was available for review.

Effect/Potential Impact
- Without a documented agreement, terms and conditions regarding activities to be performed are limited
- There is potential for disputes with the third party with minimal recourse, as well as unexpected charges
- Penalties and fines to TxDOT are possible due to noncompliance with state law

Criteria
Government Code 2155 (otherwise known as the ‘State Purchasing and General Services Act’) states:
- In the purchases of goods or services the following may be used:
  - Contract purchase procedure
  - Multiple award contract procedure
  - Open market purchase procedure
  - Reverse auction procedure
- A purchase of or contract for goods or services shall be accomplished through competitive bidding
- Competitive bidding is required if the purchase is $5,000 or more

Cause
The Innovative Financing/Debt Management Office (IFDMO) did not recognize the necessity for a contract with the arbitrage consultant.

Evidence
No contract for the arbitrage consultant Bond Logistics, LLC (BLX) could be provided. Payments to BLX over the past 2 fiscal years (FY), totaling approximately $20 thousand, did not have purchase order data within FIMS. Of the $20 thousand, approximately $15.5 thousand was in fiscal year 2012.

Management Action Plan (MAP)

MAP Owner: Jennifer Wright, Financial Analyst, Innovative Financing/Debt Management Office

MAP 3.1 – IFDMO will perform a competitive procurement for arbitrage services upon hiring additional staff.

Completion Date: April 15, 2014
MAP 3.2 – Once a firm is selected as a result of the procurement process discussed above, IFDMO will target execution of an agreement for arbitrage services.

Completion Date: May 15, 2014
Observation and Recommendation

Audit Observation (a): Support for District Reporting of the Bond Evaluation Expenditures Report (BEER)

Effect/Potential Impact:
Without documentation to support projections used within the BEER report, the reliability of the information comes into question. This may negatively impact decisions made based on the information in the report.

There is also a risk that the long term obligations for bond funded projects are not understood by the Districts who oversee each project.

Audit Recommendation:
There is an opportunity to enhance and improve understanding of TxDOT’s bond program in the Districts to promote:
- improved documentation in the BEER reporting process
- retention of documentation supporting data included in the BEER report
- faster spending of bond proceeds
- knowledge of bond related commitments and obligations

Guidance for preparing the BEER report should include:
- expectations for retaining documentation to support projections for project expenditures
- direction for methodologies used to calculate expenditure projections
- information on specific bond covenant requirements important in preserving the tax advantaged status of the bonds that funded the projects

Additional guidance from Finance should include instructions to the Construction Division and the Districts to flag bond-funded projects until specific bonds have been paid off. The flag will serve to make future TxDOT personnel aware that restrictions regarding private use and disposal exist, and to see further instructions should a question come up.
Summary Results Based on Enterprise Risk Management Framework

### Audit Results Dashboard

#### Bond Covenant Audit

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#### Scope Area Assessment

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<tr>
<th>Rating Assessment Grid</th>
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<th>Satisfactory</th>
<th>Needs Improvement</th>
<th>Unsatisfactory</th>
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### Closing Comments

The results of this audit were reviewed and discussed with Ben Asher, Brian Ragland, Jennifer Wright and Glen Knipstein in an exit conference on November 22, 2013.

We appreciate the assistance and cooperation received from the Innovative Financing/Debt Management Office and the Finance organization’s management and employees contacted during this audit. We also appreciate the assistance and cooperation with the Transportation Planning and Development Directors in the Districts where we performed testing.