OCTA

*May 22, 2019*

***To:*** Finance and Administration Committee

***From:*** Darrell E. Johnson, Chief Executive Officer

Janet Sutter, Executive Director
Internal Audit

***Subject:*** Investments: Compliance, Controls, and Reporting, July 1 through December 31, 2018

### *Overview*

The Internal Audit Department has completed an audit of investments for the period July 1 through December 31, 2018. Based on the audit, the Orange County Transportation Authority complied with its debt and investment policies; however, a few errors were identified in the fourth quarter investment and debt report, and a recommendation was made to enhance monitoring of asset-backed securities' diversification limits.

### *Recommendation*

Direct staff to implement two recommendations provided in Investments: Compliance, Controls, and Reporting, July 1 through December 31, 2018, Internal Audit Report No. 19-507.

### *Background*

The Treasury Department (Treasury) is responsible for the management of the Orange County Transportation Authority's (OCTA's) Investment Portfolio (Portfolio). On December 31, 2018, the Portfolio's book value was approximately $1.7 billion. The Portfolio consists of two managed portfolios: liquid assets for OCTA's daily operations and a short-term portfolio for future budgeted expenditures. External investment managers administer the short term portfolio, and OCTA's Treasurer manages the liquid assets portfolio.

The Investment Policy (Policy) sets forth guidelines for all OCTA investments to ensure conformance with the California Government Code. The Policy outlines permitted investments, as well as diversification guidelines. The diversification limits ensure the Portfolio is not unduly concentrated in securities of one type, industry, or entity, thereby assuring adequate portfolio liquidity should one sector or company experience difficulties.

***Discussion***

OCTA's investment activities are reviewed on a semi-annual basis by the Internal Audit Department (Internal Audit). The objective of the audit was to determine if OCTA complied with its debt, investment, and reporting policies and procedures for the period July 1 through December 31, 2018.

In reviewing the 2018 Fourth Quarter Investment and Debt Report (Report), Internal Audit found that the book value reported for the short-term portfolio was $162,768 higher than the balances per the custodial bank statements. Starting in the fourth quarter 2018, staff had begun using Clearwater system balances to complete the Report, rather than the custodial bank statements. Differences between how Clearwater and the custodial bank value Treasury Inflation-Protected Securities investments attributed to the difference. Also contributing to the difference, Clearwater had posted a factor update to the value of one mortgage-backed security in late December, whereas the investment manager did not post the same factor update and notify the custodial bank until after January. The Accounting Department records securities based on the custodial bank statements; as such, the Report does not reflect amounts booked in the financial accounting system. In addition, the balance of bank deposits was overstated by $17,996 on the Report when staff erroneously used the cash balance from the prior business day. Internal Audit recommended that additional training be provided on the preparation of investment worksheets and Reports. Also, Internal Audit recommended that Treasury use custodial statements as the basis for preparing the Reports or, if Clearwater book values are used for reporting, that reconciliations be performed and documented. Management responded that additional training has been provided and that, in the future, if Clearwater balances are used to prepare Reports, a reconciliation will be performed and documented.

In addition, Treasury did not monitor the ten percent threshold for asset-backed securities during the audit period. According to the Policy, asset-backed securities, excluding mortgages, may not exceed ten percent. In addition, several daily holding reports used to monitor investment manager compliance with investment thresholds did not evidence secondary review as required. Internal Audit recommended management implement controls to monitor the ten percent threshold for asset-backed securities and ensure secondary review of daily holding reports. Management agreed and indicated that monitoring controls are in place and secondary reviews are being performed as required.

***Summary***

Internal Audit has completed an audit of investments for the period July 1 through December 31, 2018, and has offered two recommendations for improvement.

***Attachment***

A. Investments: Compliance, Controls, and Reporting, July 1 through December 31, 2018 Internal Audit Report No. 19-507

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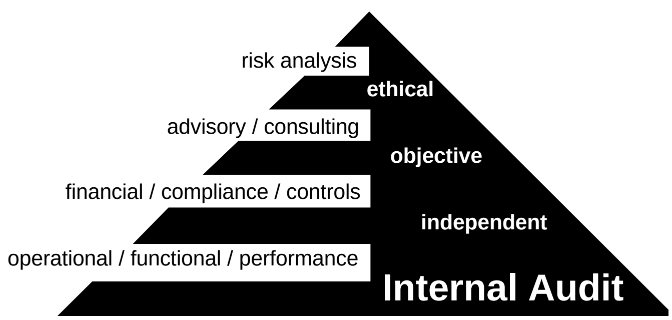
# ORANGE COUNTY TRANSPORTATION AUTHORITY
# INTERNAL AUDIT DEPARTMENT

## Investments: Compliance, Controls, and Reporting
## July 1 through December 31, 2018

## Internal Audit Report No. 19-507

**April 30, 2019**

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## Conclusion

The Internal Audit Department (Internal Audit) has completed an audit of investments for the period July 1 through December 31, 2018. Based on the audit, the Orange County Transportation Authority (OCTA) complied with its debt and investment policies; however, Internal Audit identified a few errors in the fourth quarter Investment and Debt Report and recommended enhancement to monitoring of asset-backed securities' diversification limits.

## Background

Portfolio Management

The Treasury Department (Treasury) is responsible for the management of OCTA's Investment Portfolio (Portfolio). To accomplish this, Treasury uses the Clearwater treasury software system to monitor investments and investment manager performance.

On December 31, 2018, the Portfolio's book value was approximately $1.7 billion. The Portfolio consists of two managed portfolios: liquid assets for OCTA's daily operations and a short-term portfolio for future budgeted expenditures. External investment managers administer the short-term portfolio, and OCTA's Treasurer manages the liquid assets portfolio. OCTA also has investments in debt service reserve funds for various outstanding debt obligations. OCTA's Accounting Department (Accounting) is responsible for recording all debt and investment transactions and for reconciling all bank and custodial accounts monthly.

Investment Policy

The Investment Policy (Policy) sets forth guidelines for all OCTA investments to ensure conformance with the California Government Code (CGC). The Policy outlines permitted investments as well as diversification guidelines. The diversification limits ensure the portfolio is not unduly concentrated in securities of one type, industry, or entity, thereby assuring adequate portfolio liquidity should one sector or company experience difficulties.

OCTA has provided the investment managers with a copy of the Policy and requires investment managers to invest their portfolios in accordance with the provisions of the Policy.

## Objectives, Scope, and Methodology

The primary objective was to determine if OCTA complied with its debt, investment, and reporting policies and procedures.

Audit objectives included determining if:

- Internal controls over OCTA's investment activities were adequately designed;
- OCTA was in compliance with the CGC;
- Investment transactions were adequately supported; and
- OCTA was in compliance with investment requirements of debt issuances.

According to Generally Accepted Government Auditing Standards (GAGAS), internal control, in the broadest sense, encompasses the plans, policies, procedures, methods, and processes adopted by management to meet its mission, goals, and objectives. Internal controls significant within the context of the audit objectives were evaluated as part of this audit.

The scope included investment transactions and investment-related controls for the period July 1 through December 31, 2018.

The methodology consisted of obtaining the most current Policy and Debt and Investment Management Manual, reviewing any personnel changes and corresponding updates to bank authorization signature cards, reviewing a judgmental sample of daily cash worksheets prepared by Accounting and Treasury staff, testing a judgmental sample of investments for compliance with the Policy, tracing a haphazard sample of investments from the bank statements to Clearwater, testing a judgmental sample of wire transfers for accuracy and proper authorization, and verifying the accuracy of the quarterly investment and debts reports provided to OCTA's Board of Directors. For daily cash report testing, repo-sweep testing, and wire transfer testing, Internal Audit judgmentally selected one transaction per month during the scope period. For Treasury software and computer data testing, Internal Audit haphazardly selected five securities per investment manager per quarter, resulting in a sample of 40 securities, and traced the securities from the statements to the Clearwater Daily Holding Reports. For quarterly report transaction testing, Internal Audit judgmentally selected 40 investments per quarter for coverage over different types of securities. Since the samples are non-statistical, any conclusions are limited to the sample items tested. The methodology also included Treasury's monitoring of the investment managers' compliance with the Policy, including obtaining acknowledgement of receipt of OCTA's Policy, and obtaining written descriptions of the compliance and control environment of the custodian.

We conducted this performance audit in accordance with GAGAS. 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.

## Audit Comments, Recommendations, and Management Responses

### Errors in 2018 Fourth Quarter Investment and Debt Report

The book value reported in the 2018 Fourth Quarter Investment and Debt Report (Report) for the short-term portfolio was $162,768 higher than the custodial bank statements.

Starting in the fourth quarter 2018, staff began using Clearwater system balances to complete the Report, rather than the custodial bank statements. Differences between how Clearwater and the custodial bank value Treasury Inflation-Protected Securities (TIPS) investments attributed to the difference. Also, Clearwater had posted a factor update to the value of one mortgage-backed security in late December, whereas the investment manager did not post the same factor update and notify the custodial bank until after January. Accounting staff records securities based on custodial statements; as such, the Report does not reflect amounts booked in the financial accounting system.

In addition, the balance of bank deposits was overstated by $17,996 on the Report and the Summary of Outstanding Investments worksheet for December 31, 2018. When preparing the worksheets, staff had erroneously begun using the cash balance from the prior business day.

**Recommendation:**

Internal Audit recommends that additional training be provided on the preparation of investment worksheets and Reports. Also, Internal Audit recommends that Treasury use custodial statements as the basis for preparing the Reports or, if Clearwater book values are used for reporting, that reconciliations be performed and documented.

**Management Response:**

Management agrees with the recommendation. In the future, if Clearwater book values are used for reporting, then staff will reconcile any differences between Clearwater book values and custodial statement book values. In addition, staff has already provided additional training and modified the review process in order to improve the reporting process going forward.

## Monitoring of Investment Thresholds

Treasury did not monitor the 10 percent threshold for asset-backed securities during the audit period. In addition, several daily holdings reports lacked evidence of secondary review, as required.

According to the Policy, asset-backed securities, excluding mortgages, may not exceed 10 percent of the allocation; however, there is no monitoring of the 10 percent threshold.

On a weekly basis, Treasury staff runs daily holding reports, and uses these reports to monitor investment managers' compliance with investment thresholds. Staff evidences the review by signing off on the reports and a manager, or other designated staff member, performs a secondary review. Testing identified several reports that lacked evidence of the required secondary review.

**Recommendation:**

Internal Audit recommends Treasury implement controls to monitor the 10 percent threshold for asset-backed securities and ensure secondary review of daily holding reports is performed.

**Management Response:**

Management agrees with the recommendation. Staff has been monitoring the combined threshold of 20 percent for mortgage and asset-backed securities required by the CGC but did not have a reporting process in place for the 10 percent threshold for asset-backed securities, which is a threshold more restrictive than the CGC. Staff has worked with Clearwater and is already using a report which segregates mortgage and asset-backed securities so that the 10 percent threshold on asset-backed securities can be monitored. In addition, staff has reviewed balances for asset-backed securities for all investment managers during the period and all investment managers were in compliance.

A process has been put in place to ensure that a secondary review of the daily holdings reports is performed. The Treasury Department consists of two staff members; however, the department had a vacancy during the period of the audit therefore only one review was performed for a portion of the audit period. In the future, when a position is vacant within the department the Director of Finance and Administration will perform the secondary review.