



November 13, 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, January 1 through June 30, 2019

Overview

The Internal Audit Department has completed an audit of investments for the period January 1 through June 30, 2019. Based on the audit, the Orange County Transportation Authority complied with its investment policies; however, the Internal Audit Department identified an error in the Second Quarter 2019 Investment and Debt Report and observed that the investment compliance schedule does not reflect all investments and bond indenture requirements.

Recommendation

Direct staff to implement two recommendations provided in Investments: Compliance, Controls, and Reporting, January 1 through June 30, 2019, Internal Audit Report No. 20-502.

Background

The Treasury Department (Treasury) is responsible for the management of the Orange County Transportation Authority's (OCTA's) Investment Portfolio (Portfolio). On June 30, 2019, the Portfolio's book value was approximately \$2.1 billion. The Portfolio consists of three managed portfolios: the liquid portfolio for immediate cash needs, a bond proceeds portfolio to meet Measure M2 transportation program needs, and the 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.

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

The balance of investments in the Orange County Investment Pool was understated by \$70,468, in the Second Quarter 2019 Investment and Debt Report. The audit of investments for the period July 1 through December 1, 2019, also identified an input error in the fourth quarter 2018 report. Internal Audit recommends Treasury implement and document a more robust secondary review to ensure the accuracy of investment information presented in quarterly reports to the Board of Directors. Management agreed and indicated that a more robust review process has already been implemented.

Management changed the format of the investment policy compliance schedule starting with the Second Quarter 2019 Investment and Debt Report. As a result, the schedule no longer reflects compliance monitoring of cash equivalent investments, including repurchase agreements. Also, while bond proceeds are not subject to diversification and maturity limits of the Policy, these investments are subject to requirements of their respective indentures. The indenture requirements are not currently reflected in the investment compliance schedule. Debt reserve funds are also not subject to investment policy guidelines per the schedule; however, these funds are not expressly exempted by the Policy. Internal Audit recommends that management revise the investment policy compliance schedule to evaluate all applicable investments in accordance with the Policy. Also, if management intends to exempt debt reserve funds from diversification and maturity limits of the Policy, the Policy should be updated accordingly. Finally, the schedule should include information on investment requirements of bond indentures and determination of compliance. Management agreed and had already made a change to include cash equivalents within the schedule. Also, management agreed to update the Policy to expressly exempt debt service reserve funds during the next update cycle. Finally, management agreed to include information detailing indenture requirements and compliance going forward.

Summary

Internal Audit has completed an audit of investments for the period January 1 through June 30, 2019, and has offered two recommendations for improvement.

Attachment

- A. Investments: Compliance, Controls, and Reporting, January 1 through June 30, 2019 Internal Audit Report No. 20-502

Prepared by:



Gabriel Tang
Principal Internal Auditor
714-560-5746

Approved by:



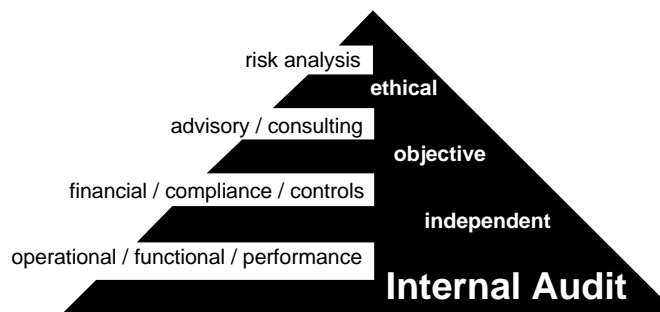
Janet Sutter
Executive Director, Internal Audit
714-560-5591

ORANGE COUNTY TRANSPORTATION AUTHORITY INTERNAL AUDIT DEPARTMENT



Investments: Compliance, Controls, and Reporting January 1 through June 30, 2019

Internal Audit Report No. 20-502
November 4, 2019



Performed by: Janet Sutter, CIA, Executive Director
Serena Ng, CPA, Senior Manager
Gabriel Tang, CPA, Principal Internal Auditor *Gang*

Distributed to: Andrew Oftelie, Executive Director, Finance and Administration
Sean Murdock, Robert Davis, Benjamin Torres, Maya Haddad

**ORANGE COUNTY TRANSPORTATION AUTHORITY
INTERNAL AUDIT DEPARTMENT
Investments: Compliance, Controls, and Reporting
January 1 through June 30, 2019
November 4, 2019**

Table of Contents

Conclusion	1
Background	1
Objectives, Scope, and Methodology	2
Audit Comments, Recommendations, and Management Responses	4
Error in 2019 Second Quarter Investment and Debt Report	4
Reporting of Investment Compliance	5

**ORANGE COUNTY TRANSPORTATION AUTHORITY
INTERNAL AUDIT DEPARTMENT
Investments: Compliance, Controls, and Reporting
January 1 through June 30, 2019
November 4, 2019**

Conclusion

The Internal Audit Department (Internal Audit) has completed an audit of investments for the period January 1 through June 30, 2019. Based on the audit, the Orange County Transportation Authority (OCTA) complied with its investment policies; however, Internal Audit identified an error in the Second Quarter 2019 Investment and Debt Report and observed that the investment compliance schedule does not reflect all investments and bond indenture requirements.

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 June 30, 2019, the Portfolio's book value was approximately \$2.1 billion. The Portfolio consists of three managed portfolios: the liquid portfolio for immediate cash needs, a bond proceeds portfolio to meet Measure M2 transportation program needs, and the 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.

ORANGE COUNTY TRANSPORTATION AUTHORITY
INTERNAL AUDIT DEPARTMENT
Investments: Compliance, Controls, and Reporting
January 1 through June 30, 2019
November 4, 2019

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 is the system of processes that an entity's oversight body, management, and other personnel implement to provide reasonable assurance that the organization will achieve its operational, reporting, and compliance objectives. The five components are control environment, risk assessment, control activities, information and communication, and monitoring.¹ The components and principles that were evaluated as part of this audit are:

- Control Environment
 - OCTA demonstrates a commitment to integrity and ethical values.
 - Management establishes, with Board of Director (Board) oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives.
 - OCTA demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives.
- Risk Assessment
 - OCTA specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives.
 - OCTA identifies and assesses changes that could significantly impact the system of internal control.
- Control Activities
 - OCTA selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels.
 - OCTA selects and develops general control activities over technology to support the achievement of objectives.
- Information and Communication
 - OCTA obtains, or generates and uses, relevant, quality information to support the functioning of internal control.

¹ See U.S. Government Accountability Office publication, "Standards for Internal Control in the Federal Government," available at <http://www.gao.gov/products/GAO-14-704G>, for more information.

ORANGE COUNTY TRANSPORTATION AUTHORITY
INTERNAL AUDIT DEPARTMENT
Investments: Compliance, Controls, and Reporting
January 1 through June 30, 2019
November 4, 2019

- Monitoring
 - OCTA evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the Board, as appropriate.

The scope included investment transactions and investment-related controls for the period January 1 through June 30, 2019. OCTA's independent auditor, Crowe, LLP (Crowe), will perform agreed-upon procedures with respect to the Treasury function for the year ended June 30, 2019. Internal Audit limited the scope of this audit to procedures that will not be performed by Crowe during the course of their agreed-upon procedures.

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. 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.

**ORANGE COUNTY TRANSPORTATION AUTHORITY
INTERNAL AUDIT DEPARTMENT
Investments: Compliance, Controls, and Reporting
January 1 through June 30, 2019
November 4, 2019**

Audit Comments, Recommendations, and Management Responses

Error in 2019 Second Quarter Investment and Debt Report

The Orange County Investment Pool balance was understated by \$70,468, in the Second Quarter 2019 Investment and Debt Report. The prior audit also identified an input error in the quarterly reports and recommended management implement monitoring controls.

Recommendation:

Internal Audit recommends Treasury implement and document a more robust secondary review to ensure the accuracy of investment information presented to the Board.

Management Response:

Management agrees with the recommendation and has already implemented the use of a more robust review process by utilizing a checklist that validates each data input and is signed by the reviewing manager to ensure the integrity of the data for the Monthly and Quarterly Investment and Debt Reports. This process was used for the Third Quarter Investment and Debt Report that was brought to the Board at the October 28th meeting.

**ORANGE COUNTY TRANSPORTATION AUTHORITY
INTERNAL AUDIT DEPARTMENT
Investments: Compliance, Controls, and Reporting
January 1 through June 30, 2019
November 4, 2019**

Reporting of Investment Compliance

Starting with the Second Quarter 2019 Investment and Debt Report, management changed the format of the investment policy compliance schedule. As a result, the schedule no longer reflects compliance monitoring of cash equivalent investments, including repurchase agreements.

Also, while bond proceeds are not subject to diversification and maturity limits of the Policy, these investments are subject to requirements of their respective indentures. The indenture requirements are not currently reflected in the investment compliance schedule. Debt reserve funds are also not subject to investment policy compliance monitoring in the schedule; however, these funds are not expressly exempted in the Policy.

Recommendation:

Internal Audit recommends that management revise the Policy compliance schedule to evaluate all applicable investments in accordance with the Policy. Also, if management intends to exempt debt reserve funds from diversification and maturity limits of the Policy, the Policy should be updated accordingly. Finally, the schedule should include information on indenture requirements and determination of compliance.

Management Response:

Management agrees with the recommendation and had already made a change to include cash equivalents within the investment policy compliance schedule. This change was reflected in the Third Quarter Investment and Debt Report that was brought to the Board at the October 28th meeting.

Management agrees that additional clarification is required to expressly exempt debt service reserve funds from the Policy. The investment of bond proceeds and debt service reserve funds held by trustees are governed by provisions of their respective bond indentures and, therefore, should be exempt from the Policy. During the most recent annual review of the Policy in May 2019, staff did seek and receive approval from the Board to exempt the investments of bond proceeds from the Policy, and the intent was to also exempt debt service reserve funds. The updated policy, dated June 10, 2019, included language noting that "Bond proceeds shall be invested in the securities permitted by the applicable bond documents." Staff will update the language within the Policy to expressly exempt debt service reserve funds during the next update cycle.

Finally, management will include information detailing indenture requirements and compliance going forward.