Texas Water Development Board

P.O. Box 13231, 1700 N. Congress Ave.
Austin, TX 78711-3231, www.twdb.texas.gov
Phone (512) 463-7847, Fax (512) 475-2053

REVIEW OF LOAN RECIPIENT MONITORING

Project # 20140102
August 2014

Our Mission

To provide leadership, information, education, and support for planning, financial assistance, and outreach for the conservation and responsible development of water for Texas

Board Members

Carlos Rubinstein, Chairman | Bech Bruun, Member | Kathleen Jackson, Member

Kevin Patteson, Executive Administrator

Project Team

Amanda Jenami, CPA, CISA, CFE, CIA, CCSA, CGAP, Director
Robert Sahm, CPA, CISA

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Executive Summary

Overview

Texas Water Development Board's (TWDB) Financial Compliance's (FC), processes provide reasonable assurance that loan recipients are monitored effectively, efficiently, and in compliance with federal, state and agency requirements. While the current loan recipient monitoring strategy is sufficient for ensuring that FC's mission is accomplished, applying a formal risk-based approach in determining the level of monitoring appropriate for each borrower or borrower category could result in a greater overall reduction of agency residual risk. The review found an opportunity to increase the coordination between FC's efforts and those of other parts of the agency (especially the loan application review teams within the Office of Water Supply and Infrastructure (WSI)), for improved credit administration. While the recent implementation of TxWISE Phase III has improved operational efficiencies (including enhanced data retention, streamlined work flows and reduced paper handling), management is aware that further improvements in TxWISE are needed. For example, the review found opportunities to enhance data quality, which would, in turn, improve data accuracy and completeness.

Background

The Annual Audit Plan for fiscal year 2014 includes a review of loan recipient monitoring. Financial monitoring of loan recipients is primarily performed by the FC team. The monitoring process includes key risk-mitigating strategies and processes such as single audit desk reviews, final accountings, site visits, and financial stability analyses aimed at ensuring compliance with federal and state sub-recipient monitoring requirements. FC employs these strategies and processes with the goal of reducing the risk of defaults, loan recipient insolvency and late payments. As of April 30, 2014, the agency had a loan portfolio totaling approximately $6 billion representing 465 entities.

Summary of Management's Response

Management appreciates Internal Audit's efforts to identify areas for improvement. Implementation of the recommendations herein will enhance administrative processes and internal controls with regard to FC. Additional information regarding actions to be taken is provided within our individual audit responses.

Closing

We would like to thank the FC team for the cooperation and assistance provided to the audit staff during this audit. For questions or additional information concerning this audit report, please contact Amanda Jenami at 512-463-7978.

Objectives and Conclusions

The overall objective of this audit was to determine the extent to which FC processes ensure that strategic and operational results and outcomes are achieved efficiently, effectively, and in a manner that ensures compliance with relevant laws, policies, and procedures.

The audit focused primarily on FC's loan recipient monitoring activities from September 1, 2012, to May 31, 2014. Fieldwork was conducted from May through June 2014. The detailed audit objectives and conclusions are described next.

Objective 1 – Operational Efficiency

1.1. Determine the extent to which financial monitoring is being performed in a manner that achieves the greatest overall mitigation of risk.

The current recipient monitoring strategy is sufficient for ensuring FC's mission is accomplished. However, applying a risk-based approach in determining the level of monitoring appropriate for each borrower could result in a greater overall reduction of agency residual risk, while improving operational efficiency. FC aims to reduce loan portfolio risk via its four primary monitoring processes – single audits, site visits, financial stability reviews, and final accountings. A risk-based approach would still employ the same methods but vary the level of individual borrower monitoring based on FC's risk assessment of the borrower. This could reduce overall agency risk by increasing the monitoring and technical expertise provided to those entities that are at greater risk of experiencing default or noncompliance**.** For example, a risk-based approach could take into account such attributes as the level of the entity's financial and managerial expertise, turnover in the entity's key management and board positions, financial stability (based on ratio and trend analysis), prior audit results, history of compliance with bond covenants, and significance of loan amount.

1.2 Determine the extent to which loan recipient monitoring processes ensure reviews are performed in a timely manner.

FC processes provide reasonable assurance that reviews are performed in a timely manner. A test of 17 final accounting reviews found them to have been performed in a timely manner.

1.3 Determine the extent to which technology is utilized to process, store, and share relevant information with other agency operations.

The implementation of TxWISE should allow staff to streamline procedures, for improved operational efficiency. The review found an opportunity to eliminate data redundancy related to final accountings within TxWISE.

Objective 2 - Operational Effectiveness

2.1 Determine the extent to which loan recipient monitoring procedures mitigate against default, insolvency, and late payments.

Loan recipient monitoring procedures provide reasonable early detection of potential borrower default, insolvency, and late payments. However, improved coordination with other parts of the agency (especially the loan application review teams within the Water Supply and Infrastructure) could reduce overall agency risk. Improved coordination could be achieved by allowing TxWISE users (e.g. FC) to place alerts within the agency's integrated loan tracking system against those entities determined to be either non-compliant or "at risk" of noncompliance or default. The current procedure is one of ad-hoc communication between FC and the loan application review teams who are charged with assessing potential borrowers' credit worthiness and general due diligence of the loan applications.

2.2 Determine the extent to which FC has set clear loan recipient monitoring objectives and performance measures.

FC's loan recipient monitoring goals and performance measures are informal and verbal. More formalized goals that are specific, measureable, achievable, realistic and time-related could improve operational effectiveness.

2.3 Determine the extent to which loan recipient monitoring processes ensure data accuracy and completeness.

FC's processes provide reasonable assurance that data contained in external communication and hard copy files is accurate and complete. The review found opportunities for improving the accuracy of single audit records within the TxWISE database. The review found that 14% (4 of 29) single audit date records tested do not match the corresponding source documents.

Objective 3 – Regulatory Compliance

3.1 Determine the extent to which FC's loan recipient monitoring procedures ensure compliance with federal, state and agency requirements.

FC processes provide reasonable assurance that the agency fulfills its sub-recipient monitoring obligations in compliance with federal requirements. The review performed testing in the areas of award identification, single audit reviews, management decisions on audit findings, and monitoring for corrective action on audit findings. All (66 of 66) of the single audits reviewed had been performed timely.

3.2 Determine the extent to which management has developed and implemented written loan recipient monitoring policies and procedures to guide staff in carrying out its day-to-day duties.

Overall, FC's loan recipient monitoring procedures provide staff with satisfactory guidance on carrying out its day-to-day operations. However, management is aware of the need to update the procedures due to the recent implementation of TxWISE, Phase III. In addition, management is in the process of enhancing written procedures with instructions on the preparation of such key reports as the Monitoring List and Stressed Entities.

Detailed Issues with Management Responses

1. Operational Efficiency: Risk-Based Review System

The current recipient monitoring strategy is sufficient for ensuring that FC's mission is accomplished. However, applying a risk-based approach in determining the level of monitoring appropriate for each borrower could result in further mitigation of agency residual risk, while improving operational efficiency. FC aims to reduce loan and grant portfolio risk via its four primary monitoring processes – single audits, site visits, desk reviews, and final accountings. A risk-based approach would still employ the same methods but vary the level of individual borrower monitoring based on their perceived risk. This could mitigate agency risk by allowing an increase in monitoring and technical expertise provided to those entities that present additional risk characteristics. Thus, focusing on achieving the greatest overall reduction of risk while providing clients with qualitative value-added input - benefiting both clients and staff. A risk-based approach could take into account such attributes as the level of the entity's financial and managerial expertise, turnover in entity's key positions, financial stability (based on agency ratio analysis), prior audit results, bond covenant compliance history, and significance of loan balance.

Recommendation

Consider improving operational efficiency by implementing a risk-based approach to determine the level of monitoring for each individual client/ client class. The risk assessment could consider the entity's financial and managerial expertise, turnover in entity's key positions, financial stability (based on agency ratio analysis), prior audit results, bond covenant compliance history, and significance of loan balance. Ideally, to maximize risk mitigation, the results of such a risk assessment would be shared with the loan/grant application review teams within WSI to aid in their due diligence reviews.

Management Action Planned:

Management agrees that implementing a risk-based system will enhance FC's overall efficiency and effectiveness. Although incorporating such a system will require significant time commitments for development and training, its overall cost/benefit should prove it to be a worthwhile investment. Management will evaluate and implement a risk-based approach for monitoring activities within FC.

Responsible Parties:

Chief Financial Officer, Director of Debt Portfolio Management, and FC Team Lead.

Estimated Completion Date:

May 31, 2015

2. Operational Effectiveness: Coordination with other agency operations

Current loan recipient monitoring procedures include ad-hoc communication between FC and the loan application review teams (within WSI) who are charged with performing due diligence reviews of the loan applications. More formalized coordination with such agency operations could reduce overall agency risk. Such coordination could be enhanced by allowing TxWISE users (e.g. FC) to place alerts within the agency's integrated loan tracking system against those entities determined to be either non-compliant or "at risk" of noncompliance and default.

Recommendation

Consider improving operational effectiveness by improving coordination with other parts of the agency (especially the loan application review teams within WSI). In addition, consider allowing TxWISE users (e.g. FC) to place alerts within the agency's integrated loan tracking system for entities determined to be either non-compliant or "at risk" of noncompliance and default.

Management Action Planned:

Installing alerts within the agency's integrated loan tracking system for entities determined to be either non-compliant or "at risk" of noncompliance and default will require requesting system enhancement to TxWISE. Management will contact the Information Technology Division to determine the feasibility of having these system changes programed into TxWISE. In the meantime, management will definitely coordinate with WSI management and develop methodologies for using existing data or features within TxWISE for communicating borrowers who are noncompliant or at-risk.

Responsible Parties:

Chief Financial Officer, Director of Debt Portfolio Management, and FC Team Lead.

Estimated Completion Date:

December 31, 2014

3. Operational Effectiveness: Data Accuracy and Completeness

FC's processes generally provide reasonable assurance that data contained in external communication and hard copy files is accurate and complete. However, the review found opportunities for improving the accuracy of single audit data within the TxWISE database. For example, 14% (4 of 29) of single audit date records tested did not match the corresponding source documents.

Recommendation

Consider improving the accuracy of single audit records within the TxWISE database by enhancing current quality control procedures to include data quality reviews. Data entered into TxWISE should be reviewed and verified on a periodic basis.

Management Action Planned:

Periodic data validity, quality, and peer reviews will be incorporated by management into the loan monitoring process to ensure the accuracy and completeness of single audit records.

Responsible Parties:

Chief Financial Officer, Director of Debt Portfolio Management, and FC Team Lead.

Estimated Completion Date:

December 31, 2014

4. Operational Effectiveness: Team Goals and Performance Measures

Most of FC's loan recipient monitoring goals and performance measures are informal. More formalized goals that are specific, measureable, achievable, realistic and time-related could improve operational effectiveness and clarity to staff and other internal stakeholders.

Recommendation

Establish formal goals and performance measures that would further improve operational effectiveness. FC could consider implementing formalized goals that are specific, measureable, achievable, realistic and time-related. In addition, consider involving all of FC in revisiting performance measures to increase the likelihood of goal accomplishment.

Management Action Planned:

Management will develop and implement goals and performance measures commensurate with FC's operations.

Responsible Parties:

Chief Financial Officer, Director of Debt Portfolio Management, and Team Lead.

Estimated Completion Date:

December 31, 2014

Appendix:
Scope and Methodology

The overall objective of this audit is to evaluate the extent to which Financial Compliance's loan recipient monitoring processes efficiently and effectively identify and reasonably mitigate agency risk through monitoring and final accounting reviews. Further, the audit sought to determine the extent to which sub-recipient monitoring provide compliance with relevant laws, policies and procedures.

The audit focused primarily on activities from September 1, 2012, to May 31, 2014. Fieldwork was conducted from May through June 2014. The detailed audit objectives and conclusions are briefly described next.

Our audit was based upon standards as set forth in the Office of Management and Budget Circular A-133, Public Funds Collateral Act, the Texas Administrative Code, TWDB's rules, and other sound administrative practices. The audit was performed in compliance with the Institute of Internal Auditors' "International Standards for Professional Practice of Internal Auditing."

Additionally, we conducted this performance audit in accordance with generally accepted government auditing standards. 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. Our evidence-gathering methods included the following:

- We reviewed applicable laws, rules, and established procedures.
- We reviewed key documents and correspondence including final accounting and single audit letters.
- We reviewed the process of completing a final accounting, a single audit desk review, a site visit, and a stability review.
- We reviewed all tracking reports.
- We conducted interviews with staff.
- We reviewed prior audits by external entities.

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TWDB Mission Statement

The Texas Water Development Board's (TWDB) mission is to provide leadership, information, education, and support for planning, financial assistance, and outreach for the conservation and responsible development of water for Texas.

Internal Audit Division's Mission Statement

Our mission is to assist all members of management and the Board with objective reports, recommendations, counsel, and information on the adequacy and effectiveness of TWDB's system of internal controls and the quality of performance in carrying out assigned responsibilities.

To obtain a hard copy of this TWDB Audit Report, please e-mail Amanda.jenami@twdb.texas.gov or call 512-463-7978.