

Texas Water Development Board

The logo for the Texas Water Development Board, featuring three stylized, overlapping blue waves to the right of the text.

Review of Debt Service Payments

Project #2017.05
August 2017

Executive Summary

We reviewed debt service¹ payments and related activities for the 4th quarter of fiscal year 2016 and the 1st and 2nd quarters of fiscal year 2017 (June 1, 2016 to February 28, 2017), as well as relevant financial reporting and disclosures required for any applicable periods. Our primary objective was to determine whether management has established adequate processes and controls to ensure that debt service payments on bonds issued by the agency are processed in accordance with applicable statutes, rules, bond covenants, and agency policies and procedures.

Overall, we found no systemic weaknesses in our review of the debt service payment process.

- Controls have been established to ensure that debt service payments on bonds issued by the agency are processed accurately, timely, and in accordance with the bond covenants and agency policies and procedures.
- A process has been implemented to monitor activities of the bond trustee responsible for making debt service payments for the State Water Implementation Revenue Fund for Texas (SWIRFT).
- Required reporting on outstanding debt was performed and submitted accurately, timely, and in compliance with applicable statutes, rules, bond covenants, and agency policies and procedures.

During the audit, new management over the finance area recognized the need to improve documentation of certain processes. Our review found that written procedures were documented for the majority of key processes and activities; however, we identified areas in which improvements should be made to enhance the effectiveness and value of those existing procedures that relate to:

- The preparation of cash flow projections,
- Monitoring activities of the SWIRFT trustee, and
- Reconciliations of debt service accounts.

We also noted that procedures should be developed for estimating and requesting the general revenue portion of debt service payments.

Consistent application of the established controls, in addition to minor additions and updates to written procedures as addressed in the report, should enhance the overall effectiveness of the agency's debt service payment processing and the related activities reviewed.

¹ Debt service is the cash that is required to cover the repayment of interest and principal on a debt for a particular period.

Background

The Texas Water Development Board (TWDB) administers financial assistance programs for water supply; wastewater treatment, distribution and collection; flood mitigation; and agricultural water conservation projects². These programs are primarily funded by the sale of general obligation bonds and revenue bonds. General obligation bonds are secured by the full faith and credit of the state. Revenue bonds are backed by pledged revenue sources and restricted funds.

Bond issuances are governed by the bond covenants,³ which include debt servicing instructions such as principal and interest due dates, payment amount, and requirements for the use and transfer of funds. Consistent with the Security Exchange Commission's (SEC) rule 15c2-12, the bond covenants also include requirements for the disclosure of information relating to debt outstanding. Additionally, 34 Texas Administrative Code § 181.10 requires all issuers of state securities to file a debt issuer report with the State of Texas Bond Review Board on a semi-annual basis.

As of August 31, 2016, the agency's bond indebtedness was approximately \$3.7 billion and consisted of the following:

Types of Bonds	Total Requirements	% of Total Indebtedness
General Obligation Bonds	\$2,288,095,000	62%
Revenue Bonds	\$1,420,345,000	38%

General obligation bonds include the Water Development Fund (WDF), the Water Infrastructure Fund (WIF), the Economically Distressed Areas Program (EDAP), and the State Participation (SP) Program. Revenue bonds include the Clean Water State Revolving Fund (CWSRF) and the State Water Implementation Revenue Fund for Texas (SWIRFT).

Debt service payments on general obligations bonds are funded either solely by loan recipient repayments or a combination of loan recipient repayments and state appropriated funds (general revenue). Debt service payments for CWSRF revenue bonds are funded entirely from the repayment of political subdivision loans, and SWIRFT revenue bonds are funded by the repayment of political subdivision obligations and funds resulting from bond enhancement agreements.

With the exception of SWIRFT bonds, which are processed by a trustee, all other debt service payments are processed by staff organizationally located in the Debt & Portfolio Management (DPM) and Accounting Divisions of the Finance Office.

² http://www.twdb.texas.gov/publications/reports/administrative/doc/StratPlan2017_2021.pdf?d=1503672962824

³ Bond covenant is a legally binding term of agreement between a bond issuer and a bond holder.

In fiscal year 2016, the agency's principal and interest payments were approximately \$320 million and consisted of the following:

- \$210 million (66%) for general obligation bonds, and
- \$110 million (34%) for revenue bonds.

Information systems used in the debt service payment process included:

- TxWISE (Texas Water Information System Enhancement) – a project tracking system used to track debt service schedules for bonds issued by the agency.
- MIP (Micro Information Product) – the internal accounting application used for processing all debt service payments.
- USAS (Uniform Statewide Accounting System) – the state of Texas's accounting system used to record payment transactions on general obligation bonds.

Objectives, Scope, and Methodology

Objectives

The primary objective of the audit was to determine whether management has established adequate processes and controls to ensure that debt service payments on bonds issued by the TWDB are processed in accordance with applicable statutes, rules, bond covenants, and agency policies and procedures.

The detailed sub-objectives included:

1. To determine whether the agency has a reliable methodology to estimate funds needed to cover debt service payments and whether the resulting forecast ensures adequate funds will be available to fulfill future debt servicing requirements.
2. To determine whether debt service payments for select bonds are made in compliance with bond covenants.
3. To determine whether debt service payments are processed effectively and efficiently.
4. To determine whether required reporting on outstanding debt is performed accurately, timely, and in compliance with applicable statutes, rules, bond covenants, and agency policies and procedures.

Scope and Methodology

The scope of this project covered debt service payments and related activities for 4th quarter fiscal year 2016 and the 1st and 2nd quarters of fiscal year 2017 (June 1, 2016 to February 28, 2017), as well as relevant financial reporting and disclosures required for any applicable periods.

The audit methodology for the audit consisted of a review of the following information:

- SEC Rule 15c2-12
- 34 Texas Administrative Code § 181.10
- Selected bond transcripts
- Debt Management Policy
- Fiscal year 2016 Annual Financial Report, CWSRF Annual Report, Legislative Appropriations Request, and Operating Budget
- Cash flow projections and supporting documentation
- Debt service schedules and related queries and reports from TxWISE
- Payment documentation for selected bonds
- Monthly reconciliations of debt service accounts and supporting documentation

Tests and procedures included the following:

- Conducting interviews with management and staff.
- Reviewing applicable statutes, rules, bond covenants, and agency policies and procedures.
- Testing a sample of cash flow projection worksheets and validating that inputs were accurate and that the resulting cash projection was sufficient to fulfill future debt servicing requirements.
- Testing a sample of bonds and validating compliance with bond covenants.
- Testing a sample of debt service payment transactions and validating that controls ensured payments were made effectively and timely.
- Reviewing the Annual Debt Issuer Report, Continuing Disclosure Report and the CWSRF Annual Report and validating that accurate information was disclosed with regards to debt service.

This engagement was conducted in accordance with *Generally Accepted Government Auditing Standards* and the *International Standards for the Professional Practice of Internal Auditing*. These 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 observations and conclusions based on our audit objectives.

The audit team consisted of:

Yania Munro, CFE, CGAP
 Nicky Carter, CICA
 Nicole Campbell, CIA, CISA

Detailed Results

We reviewed debt service payments and related activities, as well as relevant financial reporting and disclosures, to determine whether management has established adequate processes and controls to ensure compliance with applicable statutes, rules, bond covenants, and agency policies and procedures.

Our review found that controls exist to ensure debt service payments on bonds issued by the agency are processed accurately, timely, and in accordance with the bond covenants and agency policies and procedures. We also noted that a process has been established to monitor the activities of the SWIRFT trustee, and required reporting on outstanding debt was performed and submitted accurately, timely, and in compliance with applicable statutes, rules, bond covenants, and agency policies and procedures.

However, we identified areas in which improvements should be made to strengthen existing written procedures relating to the preparation of cash flow projections, monitoring activities of the SWIRFT trustee, and reconciliations of debt service accounts. We also noted that procedures should be developed for estimating and requesting the general revenue portion of debt service payments.

Written procedures establish management's criteria for executing the agency's operations, as well as enhancing both accountability and consistency. In addition, thorough procedures serve as effective training tools for staff and promote uniformity in executing and recording transactions.

1. A reliable methodology exists to estimate funds needed to cover debt service payments; however, the written procedures for this process should be updated to reflect current practices and should address all related activities.

A reliable methodology has been established that provides reasonable assurance that adequate funds will be available to fulfill future debt servicing requirements. The Debt and Portfolio Management (DPM) Division prepared quarterly cash flow projections for each program and fund. The revenue estimates used in the analysis were conservative, and specific provisions, unique to a particular program or fund, were also factored into the methodology. Documentation to support the final cash flow estimates for each quarter was retained and included evidence of manual inputs and an internal peer review process. Although written procedures exist to prepare the cash flow projections, these procedures were outdated and referenced an information system that was no longer in use.

We also evaluated the agency's process for estimating and requesting the portion of debt service payments covered by state appropriated funds (general revenue) for the EDAP and WIF programs. General revenue requests were estimated using a modified version of the quarterly cash flow projections, and included a contingency reserve. Our review compared the amount of general revenue requested against actual general revenue draws that occurred during fiscal year 2016. We found that the estimated amount of general revenue needed to cover debt service

payments for EDAP and WIF program was sufficient for fiscal year 2016. However, procedures for estimating and requesting the general revenue portion of debt service payments had not been formally documented.

2. Debt service payments were made in compliance with select bond covenants and a process exists to monitor the SWIRFT trustee; however, the written procedures for performing the reconciliation of trustee bank statements should be updated to ensure they are complete and provide clear guidance.

The following four debt service payments were selected for review to determine whether they were processed in compliance with certain key bond covenants:

Bond Description	Payment Date
General Obligation Bonds – WDF, WIF, EDAP, SP	08/01/16
Revenue Bonds – SWIRFT	10/17/16
General Obligation Bonds – Lower Colorado River Authority	11/15/16
Revenue Bonds – CWSRF	01/13/17

A payment invoice may include multiple bond series for a particular program or fund. For example, invoices for certain general obligation bonds consist of multiple bond series for WDF, WIF, EDAP, and SP. We selected the most recent bond series for each program or fund included in the payment invoice, which consisted of the following:

Description
W Fin Assistance Bonds Series 2016A – EDAP
W Fin Assistance Bonds Series 2013A – WIF
W Fin Assistance Refunding Bonds Tax Series 2013D – SP
W Fin Assistance Refunding Bonds Series 2015A – WDF
SWIRFT Revenue Bonds Series 2015A
W Fin Assistance Bonds Series 2015D - LCRA
W Dev State Revolving Fund Sub Lien Revenue Bonds Series 2009-A1 - CWSRF

Bond transcripts were reviewed to identify key covenants relating to the payment process. This included the following: (a) provisions that prescribed the creation of specific accounts for debt service, (b) due dates of debt service payments, and (c) authorization of fund transfers for the payment of debt service. Our review found that all debt service payments were made in compliance with the selected key bond covenants.

As previously noted, the agency does not process debt service payments for the SWIRFT program. The payments are processed by a trustee, who is also responsible for transferring funds to the correct accounts and notifying the agency if funds are insufficient to make the debt service payments. Our review evaluated the agency’s process for monitoring the activities performed by the trustee.

We noted that a process exists for monitoring the SWIRFT trustee. The Accounting Division performs monthly reconciliations of trustee statements to internal records. In addition, twice monthly, expected revenue receipts were reconciled to actual amounts received to ensure that funds were received and credited to the correct accounts. Fees automatically withdrawn from the bank account were also verified for accuracy. Though written procedures for performing the reconciliation of SWIRFT trustee bank statements have been drafted, our review found that these procedures were incomplete and did not address all steps within the process.

3. The processing of debt service payments was managed effectively and efficiently; however, the written procedures for performing reconciliations of related accounts should be updated to reflect current practices.

The four debt service payments mentioned above were also reviewed to determine whether they were processed effectively, efficiently, and in accordance with written internal procedures and payment deadlines. In all instances, we found that:

- Funds were sufficient to cover debt servicing requirements,
- Payments were processed within the prescribed deadlines, and
- Supporting calculations were valid and accurate.

We also noted that payment vouchers were reviewed and approved and there was adequate segregation of duties incorporated within the process. Invoices were reconciled within a reasonable timeframe and third-party confirmations for balances due were received as required.

The DPM Division was responsible for initiating the payment process, reconciling the paying agent invoices to the agency's internal records, and ensuring funds were available to make the debt service payments. The Accounting Division was responsible for ensuring funds were transferred to payment accounts, performing the actual payment transaction, reconciling fund balances to the agency's internal accounting application, and updating debt service balances in the appropriate information systems. Written procedures for reconciliations related to debt service accounts exist (MIP to USAS); however, our review found that the procedures were outdated and did not provide sufficient detail to perform the tasks.

Recommendation

A process should be implemented to ensure that written procedures are developed or updated to provide sufficient detail, reflect current practices, and address all related activities, including:

- Preparation of cash flow projections,
- Estimating and requesting the general revenue portion of debt service payments,
- Reconciliations of trustee bank statements and debt service accounts.

Management's Response: *Management will implement a process to ensure that internal procedures are reviewed every two years or as needed, and are developed or updated for the preparation of cash flow projections, the estimation and request for general revenue portions of debt service payments, and reconciliations of trustee bank statements and debt service accounts.*

Responsible Party: *Georgia Sanchez*

Implementation Date: *June 30, 2018*

Closing

We would like to express our appreciation to all of the management and personnel for their cooperation and assistance provided to the internal audit staff during this review. For questions or additional information concerning this report, please contact Nicole Campbell at (512) 463-7978.

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