



# **LONG-TERM DEBT MANAGEMENT**

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**City of Tulsa Internal Auditing**  
October 2013



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## City of Tulsa Internal Auditing

A handwritten signature in black ink that reads 'Ron Maxwell'.

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Ron Maxwell, CIA, CFE  
Chief Internal Auditor

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Clift Richards, CPA  
City Auditor

### **AUDIT TEAM:**

Steve Jackson, CPA — Internal Audit Manager  
Vicki Peters, CBA, MBA — Senior Internal Auditor  
Seth Potter — Staff Auditor II

## **INTRODUCTION**

The debt management group of the Finance Department Treasury Division has extensive responsibilities involving objectives to ensure the following:

- compliance with bond covenants,
- timely and accurate reporting to third parties,
- bond funds are appropriately allocated, invested and disbursed,
- timely and accurate debt service payments,
- arbitrage rebate penalties are accurately and timely calculated
- variable rates are set at market levels,
- investment agreements are properly collateralized,
- liquidity and credit enhancement contracts are renewed in a timely manner, and
- investment and disbursement of bond funds are coordinated to assure expenditures are in compliance with IRS Regulations and the Oklahoma State Statutes

Debt management personnel work closely with bond trustees, cash management and Accounting Division staffs to ensure bond proceeds are invested properly, funds and accounts are properly established, cash flows are adequate, and compliance with bond covenants.

## **SCOPE**

The scope of this engagement was limited to a review and evaluation of the City's debt management practices (encompassing the parameters for issuing and managing debt, accounting procedures, timing and method of sale, and structural features incorporated in the debt). Specific emphasis was directed on the effectiveness of internal controls and procedures for the administration and financial management of long-term debt including general obligation and revenue bonds issued for capital improvements and major capital maintenance. This is the first in a series of three audits planned to evaluate the long-term debt management processes in the Finance Department. Capital improvement projects and investments will be considered for audit as part of the FY 2014 Audit Plan.

## **OBJECTIVES**

1. To determine if the City's debt management practices, policies and procedures are flexible enough to allow the City to respond to changes in service priorities, revenue inflows, and cost structures.
2. To determine if the debt management process is integrated with strategic, operational, physical, and financial planning processes.
3. To determine if accounting procedures ensure that debt service expenditures are properly classified, recorded, and reported.

4. To determine if controls over regulatory and legal requirements associated with bond issuance and continuing compliance are adequate.
5. To determine if the City has internal controls to ensure compliance with bond covenants, and reporting to third parties is done timely and accurately.

## **AUDIT METHODOLOGY AND PROCEDURES**

Internal Auditing used standard audit methodology including interviews, observations, and audit testing in performance of the audit.

- Obtained and reviewed City of Tulsa (COT) Debt Management Policy and Procedures,
- Obtained and reviewed applicable laws, regulations, and rules regarding municipal debt,
- Obtained and reviewed COT Debt Service Requirements,
- Documented processes for Annual Debt Service Schedules,
- Obtained bond covenants from Treasury Division intranet and reviewed procedures for monitoring compliance with indenture requirements,
- Reviewed Master Bond Indentures,
- Reviewed Rating Agency GO Bond Ratings Letter,
- Developed and completed debt management internal control questionnaire, and
- Reviewed COT Post-Issuance Compliance Checklist and Procedures.

## **CONCLUSION**

We conducted this audit in conformance with the International Standards for the Professional Practice of Internal Auditing. Those standards require that the audit is planned and performed to obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions based on the audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Internal controls over regulatory and legal requirements are adequate. Design of the internal controls to ensure compliance with bond covenants and third party reporting is adequate. Internal controls to ensure compliance with bond covenants, debt agreements and indenture requirements have been improved since Internal Auditing completed their fieldwork.

We would like to thank Stan Jones, Treasury Division Manager, and his staff for the courtesy extended to the Internal Auditing team during this project.

## **Finding 1**

### **Debt Management Policies and Procedures**

Debt policies describe fiscal and management practices that seek to integrate long-term project needs with available financial resources. A formal debt policy should establish parameters and provide direction in the planning and implementation of a debt program. This assists management in integrating the issuance of debt with other long-term planning, financial, and management objectives. In addition, a formal debt policy is used as a tool to evaluate the impact of individual bond issues on the City's overall financial position in order to avoid exceeding acceptable levels of indebtedness. Other benefits include reducing the need for managerial direction of routine matters, efficiency improvements through standardization of actions, facilitation in training personnel, and documentation of institutional knowledge in order for operations to continue in the absence or retirement of key employees.

The City currently has written debt policies. However, in order for policies to be effective, they should be reviewed at explicit, predetermined time intervals and approved by the appropriate management levels which should include the Mayor and City Council. The City's current debt policy was issued in 1999. The policy is fairly thorough and well written but has not been reviewed, updated, and approved to reflect current operating practices and changes in applicable laws and regulations.

### **Recommendation 1**

The City's written debt policy should be reviewed, updated, and approved by management, the Mayor and City Council to reflect current operating practices and changes in applicable laws and regulations. Going forward, the policy should be reviewed at predetermined periodic intervals.

### **Management Response**

Treasury agrees that management, the Mayor and City Council should be apprised of the impact of all debt issuance and assured that it conforms to financial policies. Annually, as part of the City Council's approval of the Annual Budget and Capital Plan, various types of funding are presented as part of the document. Also incorporated in the annual budget are the City of Tulsa Financial Policies. In this section, (FY14 'City of Tulsa Financial Policies' is attached, Exhibit A) Item #7. Long-Term Borrowing, outlines management's parameters for issuance of long term debt. Treasury adheres to this statement of policy and strives to inform the City Council and authorities at the time of each issuance.

## **Finding 2**

### **Bond Covenants**

Bonds often have protective covenants written into their indentures. These often require that sinking funds be established; that any future debt related to the project be subordinate to the issue in question or that the bondholders have recourse to the physical assets in case of default. The following are examples of covenants typically found in revenue bonds:

- rate covenants which specify user charges,
- insurance covenants which specify how both the physical asset and its cash flows are to be indemnified,
- maintenance covenants which specify that the asset or assets be kept in good repair, and
- non-discrimination covenants which specify that all users of the facility being constructed or repaired must pay user fees except in times of emergency.

Ensuring compliance with every bond covenant is a key responsibility of the Finance Department and includes verifying covenant provisions regarding liquidity ratios, cash balances, and many other terms included in debt agreements to protect the interests of the debt holders. Typically, bond counsel will evaluate (and possibly opine) on compliance with certain laws and regulations related to debt issuance. An opinion or evaluation by bond counsel may lower the risk of noncompliance pertaining to recent debt issuances. However, an opinion from bond counsel will not mitigate the risk of noncompliance relating to covenants, debt retirement or reporting related to transactions or events occurring after the debt's issuance.

Current procedures may ensure compliance with provisions of the bond indentures. For bonds issued by the authorities, the bond trustees are contractually responsible for complying with bond indenture requirements, but the ultimate responsibility for the indenture requirements belongs to the City. Depending on the nature of the requirement, failure to comply with an indenture requirement could be a reportable, material event. Reportable events increase the risk of a downgrade on the issues rating and could affect the City's future bond ratings. The City would also be at increased risk to litigation from bond holders or regulatory agencies.

We reviewed the Covenants by Authority on the Treasury Division's intranet. We observed a monthly Covenant Compliance Report which if used contains all of the necessary components to ensure compliance; however, we were unable to find that this report is being used.

## **Recommendation 2**

We recommend

- a. The Treasury Division assumes responsibility for coordinating and developing procedures to ensure compliance with indenture requirements.
- b. A “point person” should be designated to identify and summarize all existing covenants for each bond issue by the appropriate Authority or the City.
- c. If monitoring of debt compliance requirements is done separately by each Authority for its respective issues, then documentation of the Authority’s compliance procedures should be provided to the Treasury Division on a regular basis which at a minimum should be no less than on a quarterly basis.
- d. We recommend that the City Council and the Mayor be kept apprised of the percent of outstanding issuances that are actively being monitored and reported upon for compliance.

## **Management Response**

Treasury agrees with this recommendation. The Debt Officer in Treasury is designated for coordination of all compliance activities related to indenture requirements and serves as the “point person” for the City and for the various authorities for whom Treasury issues debt. The Debt Officer insures that the various trustees receive the required documents, according to the indentures. Accounting coordinates several compliance activities i.e. arbitrage calculations and rebate calculations and filing disclosures with the appropriate agencies. The Comprehensive Annual Financial Report (CAFR) provides schedules of outstanding long-term debt issuances. The Notes to Basic Financial Statements within the CAFR outline how these liabilities are funded and recorded. It is Treasury’s intention to inform the Mayor, City Council and the authorities of post-issuance compliance activities on an annual basis. Treasury’s development of Post-Issuance Compliance Procedures has provided a tracking mechanism of bond activities and development of a central repository of this information makes it readily available.

## **Finding 3** **Post-Issuance Compliance**

The City must ensure that accounting and allocation of debt proceeds comply with a number of laws and regulations, including Federal Internal Revenue Service regulations for tax-exempt bonds and state law. Issuers of municipal bonds must submit continuing disclosures which are identified in Securities and Exchange Commission Rule 15c2-12 (SEC Rule 15c2-12). These disclosures are based on contractual agreements established when a bond is issued. The agreements entered into under SEC Rule 15c2-12 apply to most new issues of municipal securities. Such disclosures are classified by the type of information they contain. The Municipal Securities Rulemaking Board’s (MSRB) Electronic Municipal Market Access (EMMA) website publicly displays continuing disclosures that are provided either as required disclosures by municipal

issuers and other parties known as “obligated persons” or “obligors” under contractual agreements entered into under Rule 15c2-12 of the Securities Exchange Act of 1934. Rule 15c2-12 requires the following types of information be provided to the MSRB’s EMMA system: Financial or operational information and Event notices.

Recent changes to Rule 15c2-12 include:

- Elevated importance of the Office of Municipal Securities by hiring additional staff.
- Expanded the requirements of the Rule where many events now may require filing whether or not historically deemed material.
- All Event notices must be filed with EMMA within ten business days following the occurrence of a reportable event for bonds issued on or after December 1, 2010 which makes complying difficult.
- The SEC Alerts emphasize due diligence and disclosure procedures for municipal securities.
- Issuers must now file a “failure to file” notice if the information they promised to provide is not available within the period specified in the contract at the time of the primary offering.

Best practices call for written procedures to be in place to assure no lapses in filing will occur even if staff turnovers occur. All responsible staff members should be aware of written procedures and applicable “stake holders”, i.e. Mayor and City Council members, Legal Counsel, Bond Counsel, Finance Director, and appropriate members of the Mayor’s team. Controls should be in place to ensure all continuing disclosure document covenants are met, i.e., audited financial information plus statistical information must be filed. Record retention requirements are for the life of the bonds plus three years. Receipts of filings should be maintained over the life of the bonds. The Electronic Municipal Market Access (EMMA) does not retain receipts.

On October 24, 2011, the MSRB expanded its enforcement support with an agreement to assist the Internal Revenue Service. Under federal securities law, the MSRB has a statutory mandate to provide enforcement support to regulatory authorities. According to MSRB executive director Lynnette Hotchkiss in the October 2011, **The Bond Buyer** “This is the first time we’re providing data to a regulatory organization to help them *enforce their laws*.”

Risks of non-compliance with post-closing requirements have substantially increased as typical bond documents hold issuers responsible for any damages stemming from loss of tax exempt status. The cost of a closing agreement can be expensive depending on the severity of the non-compliance. The IRS has stated Issuers who have adopted written policies and procedures will be given favorable treatment versus those who haven’t adopted written policies and procedures. Failure to attend to post-issuance compliance requirements can have serious federal tax or securities law consequences.

In our discussions with the Finance Department, we were told that in the past there were no written procedures with respect to post-issuance compliance but that the Bond Counsel for the City of Tulsa has agreed to provide assistance in this matter. We obtained these written procedures and want to acknowledge that progress has been made in initiating procedures for those designated with post-issuance compliance responsibilities.

### **Recommendation 3**

The following recommendations are made to further enhance the steps currently being considered by management.

- a. The written post-issuance compliance policy should be reviewed (and such review documented) and approved by management.
- b. Evidence of formal adoption and implementation of post-issuance compliance procedures as noted will be favorably considered by the Internal Revenue Service. Individuals responsible or the positions responsible for compliance should be adequately trained in Securities and Exchange Commission (SEC) and IRS regulations along with other state and federal post-closing requirements.
- c. Written documentation of those trained including the dates they received training should be maintained.
- d. The current written procedures state that responsibility for post-closing compliance lies with the Director of Finance and that day-to-day compliance will fall among multiple offices and persons. It is our recommendation that a "point person" be formally designated as responsible for ensuring the City and the associated Authorities are in compliance with post-issuance requirements and that this person be required to issue in writing to the Director of Finance on no less than a semiannual basis the status of the City of Tulsa and its associated Authorities with respect to post-issuance compliance requirements.

### **Management Response**

Treasury agrees with this recommendation. Shortly before Internal Audit began their review of long term debt procedures and policies, Treasury began meeting internally to develop written Post Issuance Compliance Procedures. Several staff members from Accounting, Budget/Capital Planning, Treasury, and Engineering met with the City's Bond Counsel to review the IRS requirements and the reporting scope. Specific responsibilities were determined along with position assignments. An electronic repository of all of the required documents was established with Treasury's 'point person' collecting the data. For each issue of debt a post issuance compliance checklist will be executed designating the responsible parties. The written procedures were completed and the first hearing was conducted on July 22, 2013. The procedures outline that the Director of Finance shall receive a report from the hearing officer of any findings and shall determine the appropriate action to be taken.

Treasury is fully aware of the importance of maintaining a favorable bond rating and the critical nature of insuring compliance with debt covenants and IRS requirements for issuing tax-exempt debt. Staff will pursue training opportunities, when funding is available, to strive to keep current on changing regulations, as well as, pursuit of 'best practices' to continue to improve our procedures and compliance efforts.

## **Distribution List**

Mayor
Councilor, District 1
Councilor, District 2
Councilor, District 3
Councilor, District 4
Councilor, District 5
Councilor, District 6
Councilor, District 7
Councilor, District 8
Councilor, District 9
City Auditor
Mayor's Chief of Staff
City Manager
Press Secretary
MRO Director
Director of Finance
Senior Administrative Services Officer
Treasury Division Manager
Controller, Accounting Division
Budget Division Manager
Council Administrator
Council Secretary
External Auditor
Mayor's Advisory Audit Committee
Internal Auditing Staff