BERNALILLO COUNTY
NEW MEXICO

Bond Funds

Internal Audit

January 2020

REDW LLC
CPAs | Advisors

Bernalillo County Internal Audit
Bond Funds

Executive Summary

SUMMARY OF PROCEDURES

REDW performed internal audit procedures focused on evaluating debt policy compliance, bond requirement, bond proceeds, use of bond proceeds, the timely expenditure of the bond proceeds, arbitrage of the bonds and lastly the monitoring of the bonds to determine if these processes were in compliance with department policies and procedures, County Administrative Instructions and applicable laws and regulations.

We performed the following procedures:

- Tested requirements according to the Debt Management Policy to ensure administrative responsibilities were being adhered to by the Debt Advisory Committee and debt management administration.
- Selected a sample of GO and GRT bonds, testing to ensure financial measures under both types of bonds were in compliance with the Debt Management Policy.
- For the sample of GO and GRT bonds selected, tested to ensure compliance guidelines related to the segregation and investment of bond funds were in compliance with the Debt Management and Investment Policies.
- For the sample of GO and GRT bonds selected, selected a sample of expenditures under each bond and tested to ensure bond proceeds were spent in accordance with the purpose of bond and whether approval requirements as stated on the Debt Management Policy were followed.
- For the sample of GO and GRT bonds selected, tested whether expenditures of bond proceeds appeared to timely, in accordance with the Debt Management Policy and IRS Arbitrage Requirements.
- Tested whether the most recent closed bond complied with arbitrage requirements as stated in the Debt Management Policy.
- Inquired whether any transcript changes have made to any of the outstanding bonds.

Albuquerque
7425 Jefferson St NE
Albuquerque, NM 87109
P 505.998.3200
F 505.998.3333

Phoenix
5353 N 16th St, Suite 200
Phoenix, AZ 85016
P 602.730.3600
F 602.730.3699

SUMMARY OF OBSERVATIONS AND RECOMMENDATIONS

REDW observed areas during the course of the audit where controls were functioning properly and established procedures were followed. Our testing identified that bond proceeds appear to be properly segregated, invested and utilized for their intended purposes.

As a result of our testing, REDW identified one moderate risk observation.

BOND SPENDING PLANS

Four of five bonds either did not meet or potentially will not meet the 85% spending requirement by year three as required by the IRS. We recommend a semi-annual check-in of spending percentages to determine if the process updates are having the intended effect. In addition, we recommend Finance work with Procurement to see if there are ways to gather information via Request for Information (RFI) or alternate means prior to bond issuance for specific bond projects where the turnaround time may be significantly impacted.

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Further detail of our purpose, objectives, scope, and procedures are included in the internal audit report.

We received excellent cooperation and assistance from the Bernalillo County personnel during the course of our interviews and testing. We sincerely appreciate the courtesy extended to our personnel.

REDW LLC

Albuquerque, New Mexico
February 6, 2020

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Report

INTRODUCTION

We performed the internal audit services described below solely to assist the Finance and Accounting Departments at Bernalillo County in evaluating compliance with the Debt Management Policy and Guidelines. Our services were conducted in accordance with the Consulting Standards issued by the American Institute of Certified Public Accountants and the terms of our Professional Services Contract agreement for internal audit services. Since our procedures were applied to samples of processes, it is possible that significant issues related to the areas tested may not have been identified.

Although we have included management's responses in our report, we do not take responsibility for the sufficiency of these responses or the effective implementation of any corrective action.

An entrance conference was held on December 12, 2019, and fieldwork began December 18, 2019. An exit conference was held on January 24, 2020.

PURPOSE AND OBJECTIVES

Our internal audit focused on evaluating debt policy compliance, bond requirements, segregation and timely use of bond proceeds, arbitrage monitoring and lastly the monitoring of the bonds to determine if these processes were in compliance with department policies and procedures, County Administrative Instructions and applicable laws and regulations.

SCOPE AND PROCEDURES PERFORMED

In order to gain an understanding of the processes and laws/regulations, we interviewed the following personnel:

- Denise Benavidez, Principal Financial Management Analyst
- Kim Rosales, Senior Financial Accountant
- Timothy J. Olivas, Special Projects Coordinator

Albuquerque
7425 Jefferson St NE
Albuquerque, NM 87109
P 505.998.3200
F 505.998.3333

Phoenix
5353 N 16th St, Suite 200
Phoenix, AZ 85016
P 602.730.3600
F 602.730.3699

In order to gain an understanding of the processes we read relevant portions of:

- Bernalillo County Debt Management Policy and Guidelines, Amended June 25, 2019
- Bernalillo County Investment Policy, Amended September 2019
- IRS-Complying with Arbitrage Requirements: A Guide for Issuers of Tax-Exempt Bonds

We performed the following test work:

Debt Policy Compliance: We obtained and read the Debt Management Policy and Guidelines and tested to ensure the following requirements were performed:

- An annual assessment of the County's ability to issue and repay debt utilizing financial benchmarks;
- A review of expenditures of bond proceeds and the status of various projects being financed, including the capital improvement program for timeliness of spent bond proceeds;
- A review and recommendation of changes to the Debt Management Policy and Guidelines based upon the Deputy County Manager of Finance's (DCMF) review of operations;
- A review and recommendation of changes to Post Issuance Tax and Securities and Compliance Guidelines that formalize post issuance compliance controls and procedures related to the County's financial obligations;
- Preparation of an annual report to Commission;

In addition, we determined if the Debt Advisory Committee consisted of members in positions identified in the Policy.

Bond Requirement: We obtained a listing of all outstanding bonds, both General Obligation Bonds (GO) and Gross Receipts Tax (GRT) Revenue Bonds as of June 30, 2019 (total population of 17 and 7, respectfully), selecting three GO and two GRT Bonds. For General Obligation Bonds and Gross Receipts Tax Revenue Bonds, we ensured measurements were met in accordance with the Debt Management Policy and Guidelines. Additionally, we tested to ensure the weighted average maturity of the bonds issued did not exceed 120% of the weighted average economic life of the bond-financed assets.

Bond Proceeds: For the five bonds selected above, we tested to ensure:

- Bond Proceeds were maintained in a separate account;
- Bond Proceeds were invested in accordance with the Investment Policy.

Use of Bond Proceeds: For the five bonds selected above, we selected three months (February, March, and April) for which we obtained the detail of expenditures. We selected ten expenditures for each bond and tested to ensure:

- Bond proceeds were spent on capital expenditures, or other eligible expenditures based on documentation maintained in the bond transcript;
- Requisitions to the Trustee for bond proceeds to fund the project included details on project costs incurred and review and approved by the DCM Finance;
- If a requisition was deemed to include expenditures for anything other than a capital expenditure, Bond Counsel was consulted prior to making the requisition.

Timely Expenditure of Bond Proceeds: For the five bonds selected above, tested to ensure timely spending requirements according to the Debt Management Policy and Guidelines, as well IRS Arbitrage Requirements were met for each individual fund, these included:

- Have a binding obligation to a third party within six-months of the bond's issue date to allocate at least 5% of the net sale proceeds to expenditures for the capital project;
- Allocating at least 85% of the bond's net sale proceeds for expenditures on the capital project within three-years of the bond's issue date;
- If proceeds were not spent timely, the County maintained support determining if interest earned would require arbitrage calculations and potential rebate payments.

Arbitrage: Obtained the arbitrage calculation for any bonds having hit their five-year mark during fiscal year 2019. For GO Bond Series 2015 tested to ensure:

- Report of rebate calculation was reasonable and submitted timely;
- Investment restrictions in the Tax Certificate were in compliance with yield restriction rules and rebate requirements;
- Compared the yield amounts to the interest earned on proceeds and determined if the interest earned was greater than the bond yield. If so, traced the overage amount to a payment to the IRS;
- Copies of all arbitrage rebate reports were retained.

Monitoring: Inquired whether there have been any changes to the transcripts of any outstanding bonds to determine whether Bond Counsel was promptly notified and consulted to verify that there were no adverse effects on the tax-exempt status of the bond issue.

OBSERVATIONS, RECOMMENDATIONS AND MANAGEMENT RESPONSES

REDW observed areas during the course of the audit where controls were functioning properly and established procedures were followed. Our testing identified that bond proceeds appear to be properly segregated, invested and utilized for their intended purposes.

As a result of our testing, REDW identified the following observation.

BOND SPENDING PLANS

Bond funds have specific spending requirements to ensure compliance with IRS arbitrage requirements as well as the Debt Management Policy. According to the IRS, a three-year temporary period is available for bond proceeds expected to be utilized for acquisition or construction costs related to a capital project. During this temporary period, the County may invest bond proceeds at an unrestricted yield without causing the bonds to be arbitrage bonds under the yield restriction rules so long as certain provisions are met including, at least 85% of the net sale proceeds allocated to expenditures within three-years of issue. Our testing determined four of the five bonds tested either did not meet or potentially will not meet the IRS rule:

- The following bond did not meet the three-year, 85% rule:
  - The GO Series 2015 Bond achieved a 78% spending percentage.

- The following bonds potentially will not meet the three-year, 85% rule:
  - The GO Series 2018 Bond has achieved 23% spending with a three-year limit of August 2021;
  - The GO Series 2017 Bond has achieved 73% spending with a three-year limit of March 2020;
  - The GRT Series 2017A Bond has achieved 28% spending with a three-year limit of November 2020.

Potential Risk: Moderate—If bond spending is not monitored appropriately, there is a risk the three-year temporary period will expire without the adequate spending percentage being met thus potentially triggering the yield restriction rules. This risk is reduced from high as Finance has made significant steps in improving the spending and monitoring process to ensure bonds meet the IRS requirements.

Recommendation: As a mitigating measure, Finance has recently made improvements to the bond process such as analyzing if bonds truly need to be issued, re-evaluating the current spending process, and facilitating discussion with other departments on ways to ensure funds are spent timely however, Finance should monitor this improvement appropriately to ensure the process updates are functioning. We recommend a semi-annual check-in of spending percentages to determine if the process updates are having the intended affect. In addition, Finance should work with Procurement to see if there are ways to gather information via Request for Information (RFI) or alternate means prior to bond issuance for specific bond projects where the turnaround time may be significantly impacted by the RFP process.

Management's Response: Management agrees with the auditor's recommendation for improving and monitoring spending plans. The Finance Division met to discuss how to assist departments to improve and implement spending plans to reduce the risk of triggering the yield restriction rule as set by the Internal Revenue Service (IRS) Section 148 (a).

The Finance Division Staff recently started meeting with departments individually on a monthly basis to educate and assist in understanding the cash flows of large capital projects. To ensure continued progress, the County will continue this effort. Additionally, many capital projects have multiple funding sources. The County has established and communicated to departments the order of spending as, bond funds, grants, and general fund. In accordance with the IRS Reasonable Expectations, the Finance Division will proceed by working with departments to project accurate spending expectations and request vendors to provide draw down schedules for large capital projects.

Management agrees that the General Obligation Series 2015 did not meet the three-year temporary period of 85% of net proceeds allocated to expenditures on capital projects, however, the County did not owe positive arbitrage and was not responsible for a yield reduction payment. The bond issue was fully expended, the final computation date was within the five-year period and investment securities did not exceed the permitted yield required by the IRS rebate rules.

Given the volatility of the yield curves, the Finance Division will implement a voluntary three-year arbitrage calculation for each outstanding bond series. This will identify if bonds are invested appropriately to avoid positive arbitrage or yield reduction payments when the five-year bond arbitrage calculation is performed or the proceeds of the bond is fully expended as required by the IRS.

PROCESS IMPROVEMENT OPPORTUNITY

As a result of our testing, REDW identified the following process improvement opportunity.

BOND TO BUDGET SPREADSHEET

Bond expenditures are currently tracked on a spreadsheet that is updated monthly. Balances are then tied to the general ledger to ensure accuracy. There is no review process by someone other than the preparer in place to ensure amounts input into the spreadsheet are accurate. The County should consider implementing a review process on the spreadsheet to ensure amounts input are accurate.

Management's Response: In response to the process improvement opportunity, the County has implemented a formal review process by the Accounting Office Management or designee to ensure amounts are accurately reflected in the Bond to Budget Spreadsheet before distribution.

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This report is intended for the information and use of Bernalillo County Management, the audit committee, members of Bernalillo County Commission and others within the organization.

We discussed and resolved other minor observations with management and received excellent cooperation and assistance from the Bernalillo County personnel during the course of our interviews and testing. We sincerely appreciate the courtesy extended to our personnel.

REDW LLC

Albuquerque, New Mexico
February 6, 2020