

# Comments/Testimony: Little Hoover Commission

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## INTRODUCTION

The responsibility of issuing and managing debt cannot be taken lightly. It is safe to assume, that most finance directors and staff were not hired because of their knowledge and experience in the capital markets, but rather for their accounting, budgeting or other more traditional finance related knowledge and skills. They often work with a small staff and wear multiple hats and juggle multiple tasks simultaneously.

So what do they do when they actually have to raise funds to pay for capital projects? Of course they hire a battery of professionals and rely on their expertise and advice, sometimes almost entirely. That may work to get the deal done, but it is never in the best interest of the governmental entity in the long run or removes the issuer's initial and ongoing responsibilities to the markets. While there are a number of highly qualified and trustworthy professionals in the field, when the deal closes and the "funds are in the bank" those professionals are usually gone (out of the picture) and the issuer must still comply with all of the commitments agreed to in the bond documents, ensure that the proceeds are properly spent in timely manner and keep investors adequately informed. Another challenge is to ensure that the spending decisions and the timely use of the bond proceeds are appropriate and achieved which is often controlled by others in their organization. While the spending authority may come through the budget process, the timing is typically based upon the actions of the public works staff, utility staff, etc.

So, what is the financial professional to do. There are a number of "best practices" released by various professional organizations. The Government Finance Officers Association (GFOA) has a series of publications that cover selecting your financing team, the mechanics of a bond sale, the role of elected officials, as well as white papers that discuss the pros and cons of various bond structures and bond products. What appears not to exist is a best practice for monitoring, reporting and controlling the use of bond proceeds.

This became very apparent following the Association of Bay Area Governments (ABAG) scandal which was uncovered during an audit of unused bond funds. As one of the factors influencing his decision, Treasurer John Chiang recognized the need for better reporting requirements and greater transparency when it comes to the use of bond proceeds and convened a Task Force on Bond Accountability.

The Task Force was comprised of 12 members from various disciplines, all with public finance/debt experience. The Task Force paid special attention to the challenges posed by conduit financings to the use of an internal control system. Because the issuer and borrower are not necessarily related entities, some accounting, recordkeeping, and reporting functions may be handled by the conduit issuer, giving the borrower varying degrees of control over the bond funds. Even if the borrower has developed an adequate internal control system it may not always cover the operations of the conduit issuer. As a result, the Task Force identified the need for borrowers to assume responsibility for the bond funds and develop the appropriate legal and administrative framework to ensure that the bond funds are subject to its internal control system.

Based upon the Task Force's observation that some public agencies may not have an adequate control system to manage their bond funds, the final Task Force Report (Report) included a set of 17 guidelines that, if used, will help to ensure that bond funds are appropriately managed. These guidelines are intended to be layered on top of an existing system for the purposes of providing and strengthening controls over the management of bond funds.

The Task Force also concluded that there needs to be efforts to educate elected officials and managers on not only the guidelines, but also their specific roles and responsibilities when accessing the capital markets and for greater openness regarding the use of bond funds. The Task Force recognized that public agencies should create channels, whether citizen's committees or websites, to explain to taxpayers what they do with the money received from selling bonds.

## **BACKGROUND ON THE TASK FORCE**

The Mission and Scope of Work of the Task Force as laid out by Treasurer Chiang was:

### **Mission Statement**

To develop and recommend practices that enable public agencies to ensure that bond proceeds are used only for legal and intended purposes and that they are properly accounted for, managed, and safeguarded in a manner consistent with applicable legal requirements and with best practices and internal controls and transparent to the public.

### **Scope of Work**

In an effort to protect public agencies and their constituents from the misuse of bond proceeds, the Task Force on Bond Accountability will undertake the following scope of work in an advisory role to the California Debt and Investment Advisory Commission:

1. Identify the range of practices employed by public agencies and other fiduciaries that receive and disburse bond proceeds.
2. Evaluate these practices to identify increased protections against mismanagement or misuse of proceeds.
3. Establish best practice guidelines for public agencies that provide administrative and accounting controls and oversight of the administration of bond proceeds.
4. Recommend administrative practices that institutionalize and operationalize the use of these guidelines. (Specifically, to consider imbedding best practice standards in controlling documents, audit programs, and definitions of roles and responsibilities of administrative and elected officials.)
5. Promote the adoption of best practice guidelines through publications, training, or other means.
6. Consider legal, administrative, and organizational strategies to increase transparency and oversight of the administration of bond proceeds by public agencies.

In fulfilling the Scope of Work, the Task Force believed that the adoption and application of the proposed Best Practice Guidelines will go a long way in achieving the following outcomes, among others:

1. Provide a set of generally accepted practices that help to ensure the proper management of public funds by public agencies, irrespective of the type of agency, type of proceeds, or types of projects financed with bond proceeds;
2. Address the inconsistencies or gaps in best practices that apply to the related fields of financial operations, including accounting, auditing and reporting, or debt financing;
3. Provide core principles and practices that can be used to train new staff and ensure continuity of roles and responsibilities;
4. Establish a framework of review that may be used by auditors to evaluate whether public agencies apply a system of internal controls to manage the expenditure of bond proceeds;
5. Provide those who hold a fiduciary responsibility for the management of bond proceeds with a framework necessary to meet this obligation and, in so doing, help them achieve organizational goals; and
6. Enable the public to participate in the process of understanding and assessing the benefits of bond financing and the efficiency and effectiveness with which these funds are administered by public officials.

### **Task Force Proceedings**

The Task Force held five meetings over a period of eight months in various locations throughout the State and gathered information on the internal controls and practices employed by public agencies to manage bond proceeds through different means, including:

- Speaker presentations;
- Staff research and reports;
- Task Force member expertise; and
- Case studies of California issuers.

Speakers/presenters were also from different disciplines with various roles in the capital markets.

The final report of the Task Force dated December 14, 2015, can be found on the Treasurer's website and I will not go through all of the details of the report, but let me highlight some of the findings and recommendations.

## **FINDINGS**

While most findings were not a surprise to the Task Force, they were worth noting in the final Report. These included:

1. There are many difference between Public Agencies
2. There are unique challenges posed by Conduit Financings
3. It is extremely important to have a good and current Debt Policy
4. Good Internal Controls are essential to help guard against fraud and abuse
5. Different Organizations have different levels of Internal Controls
6. Integration of policies, procedures, and information is important
7. There needs to be adequate review and oversight regarding the use of bond proceeds
8. It is important to include specific financial and administrative procedures into the Bond Documents
9. There may be documents other than the indenture that control the administration of proceeds
10. There are “general” contents of an Indenture between an Issuer and Bondholder
11. There are often already existing requirements to report on Bond Funds
12. There are often existing requirements to establish and apply Internal Controls
13. There are definite differences between performance and financial audits
14. There are many different ways public agencies make the use of bond proceeds transparent
15. There needs to be a balance between reasonable assurances versus absolute assurances
16. Good internal controls may be transferable within the organization
17. Project management and controls must be linked to the reporting process

Internal control practices designed to oversee a public agency’s administration of general, operational funds may not be sufficient to oversee the disbursement of bond funds. The authority, record keeping, and reporting of expenditures of bond funds may require different processes than those set up to administer other governmental funds. As a result, public agencies may need to institute additional roles or procedures to ensure that the use of bond proceeds is consistent with legal and regulatory requirements and with program and policy objectives. They may on occasion need to use external service providers to fill roles and perform duties not assignable to staff.

## **GUIDELINES**

The Guidelines presented in the Final Report were offered on the assumption that public agencies have developed and implemented a system of internal controls that provide a reasonable assurance that the agency is properly managing its financial affairs. Because public agencies have adequate resources to guide them in the development of an internal control system, the Guidelines were not intended to direct public agencies in this effort. At a minimum, public agencies should apply the same internal controls to bond funds as they would apply to other governmental funds. However, because bond proceeds represent a more restricted source of capital, in legal, financial, and practical ways, the Guidelines presented here are complementary and in addition to the internal control practices that the agency should already have in place.

Furthermore, it is their obligation to provide this information to the public they serve and the taxpayers, who in providing the explicit or implicit authority to issue bonds, deserve a reasonable assurance that the bond proceeds are being used legally and for the purposes intended by that authority.

The Task Force did recognize that these Guidelines may not be universally applicable and recommended that those public agencies that find one or more of them difficult to implement, they should identify other compensating controls to achieve the same level of assurance intended by the implementation of these Guidelines.

The Task Force also recognizes that in order for public agencies to benefit from a robust control system, these Best Practice Guidelines must be institutionalized into the agency's accounting and administrative procedures. To support this, the Guidelines include tools and checklists that will make it easier for public agencies to achieve the purposes behind the Guidelines. In addition, the Task Force recommended:

1. Audit programs be amended to include, if they do not already, tests of the control system, the compliance system, and the internal communication systems used to track and monitor expenditures and fund balances.
2. The agency's policies and procedures must be updated to include the control system and to create a set of interlocking policies and procedures that cover the spectrum of roles and responsibilities associated with the administration of proceeds.
3. Public agencies should establish an oversight body to provide independent review of the bond program. This may be internal or external to the agency, but it must be afforded the authority and resources needed to exercise control over the program when necessary.
4. Public agencies should embrace advancements in electronic communications to provide information to the public on its bond programs. This information should include a detailed accounting of bond proceeds and the purposes and uses of expenditures at the project level. The information should be current and be sufficient to enable the public to understand the benefit of financing public facilities or services with debt.

The guidelines were grouped into five areas to correspond with areas of concern and to tie into the broader findings and recommendations. The areas and guidelines are:

### **Control Environment**

*Guideline 1— Responsibility resides with the public agency's governing body for establishing and maintaining an internal control system.*

*Guideline 2— Establish the organization's structure and lines of reporting and appropriately assign authority and responsibility to staff to implement the internal control system.*

*Guideline 3— Ensure an independent governing body oversees internal control measures.*

*Guideline 4—Ensure that the public agency's policies and procedures are consistent with and reflective of its internal control system.*

*Guideline 5—Commit to recruiting, enabling, and retaining competent personnel.*

*Guideline 6—Ensure job descriptions define responsibilities for complying with the public agency's internal control system.*

### **Risk Assessment**

Guideline 7—*Clearly define objectives of the public agency's debt issuance and administration program.*

Guideline 8—*Identify and analyze relevant risks.*

### **Control Activities**

Guideline 9— *Establish control activities that provide a reasonable assurance that the agency will meet the objectives of its bond program.*

Guideline 10— *Require that an approving officer of the public agency certify that the agency has complied with its internal control system before disbursing bond funds.*

Guideline 11—*Administer an annual compliance test to ensure the agency has fulfilled its reporting obligations on issued bonds.*

### **Information and Communications**

Guideline 12— *Establish a fund and account structure that records the expenditure of bond proceeds in sufficient detail to enable the agency to evaluate the use of the proceeds and to communicate the outcome of these expenditures.*

Guideline 13— *Regularly report to members of the public and other interested parties on the outcomes of expenditures of bond funds.*

Guideline 14—Information and Communication  
*Establish a process to alert responsible personnel to changes in the public agency's internal control system.*

Guideline 15—Information and Communication  
*Train agency personnel, including board members, management, and staff, responsible for bond administration and compliance efforts.*

### **Monitoring**

Guideline 16— *Implement a monitoring program to determine the effectiveness and efficiency of the agency's internal control system.*

Guideline 17— *Establish a process to annually review the agency's internal control system.*

### **CONCLUSION**

There is a general recognition that internal controls, guidelines, best practices, oversight, etc. are only as good and affective if implemented and adhered to. Nothing the Task Force come up with or any system of internal controls can or will prevent someone who is intent on breaking the law from trying and sometimes succeeding. We can hope that with more transparency comes more questions and sunshine which will make it more difficult. Also, the vast majority of public officials have every intent on doing

the right thing. The challenge often arises because of limited resources and knowledge and best practice literature and the kinds of recommendations coming out of the Task Force hopefully helps.

I will leave you with one last thought/challenge. There are circumstances where even with the best of intentions it may be difficult to ensure total transparency and compliance. An example may be a statewide bond measure whereby the State issued bonds for a particular activity. Those proceeds are then sometimes distributed as grants to local governments who may then further grant them to local non-profit organizations, all with the intent to carry out the original purpose of the bonds. The initial issuer (the State in this case) has a daunting task of “following the money”.

Thank you for your time.