Prince William County

Prince William County, Virginia
Internal Audit Report – Debt Management

June 21, 2019

RSM

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TRANSMITTAL LETTER

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June 21, 2019

The Board Audit Committee of
Prince William County, Virginia
1 County Complex Court
Prince William, Virginia 22192

Pursuant to the internal audit plan for calendar year ("CY") 2019 for Prince William County, Virginia ("County" / "PWC"), approved by the Board of County Supervisors ("BOCS"), we hereby present the internal audit of debt management. We will be presenting this report to the Board Audit Committee of Prince William County at the next scheduled meeting on September 17, 2019.

Our report is organized into the following sections:

Executive Summary	This provides a high-level overview and summary of the observations noted in this internal audit, as well the respective risk ratings.
Background	This provides an overview of the process, as well as relevant background information.
Objectives and Approach	The objectives of this cycle audit are expanded upon in this section, as well as a review of the various phases of our approach.
Observations Matrix	This section gives a description of the observations noted during this internal audit and recommended actions, as well as Management's response including responsible party, and estimated completion date.

We would like to thank the staff and all those involved in assisting our firm with this internal audit.

Respectfully Submitted,

RSM US LLP

Internal Auditors

PRINCE WILLIAM COUNTY

EXECUTIVE SUMMARY

Background

Prince William County: The process of issuing debt by the County begins during the long-term budget planning process, through the Six-Year Capital Improvement Program ("CIP"). The CIP is adopted by the BOCS as part of the annual budget cycle. According to the CIP schedule, staff determine the optimal time to issue project related debt based on cash flow needs and market considerations. Once a bond proceeds funding course is approved in the budget, the County and Bond Counsel prepare draft bond documentation in advance of a planned bond sale. The BOCS then passes a resolution authorizing the issuance and sale of the bonds.

Bonds proceeds are deposited into an individual account with the Virginia State Non-Arbitrage Program ("SNAP"). All drawdowns of bond proceeds are approved by the Director of Finance. Bond proceeds are scheduled to be drawn within 24 months of issuance in accordance with Internal Revenue Service ("IRS") rules for arbitrage.

Prince William County Schools ("PWCS"): The process of issuing County debt to finance School projects begins during the long-term budget planning process, through the PWCS 10-Year CIP, which is approved by the School Board prior to submission to the County for inclusion in the annual budget. Once approved by the BOCS during the annual budget cycle, the County and bond counsel prepare draft bond documentation in advance of a planned bond sale. School bonds are typically sold through the Virginia Public School Authority ("VPSA") bond program. The BOCS then passes a resolution authorizing the issuance and sale of the bonds.

Bond proceeds are deposited into an individual account with SNAP. All drawdowns of debt proceeds are approved by the County's Director of Finance. Debt issuances are scheduled to be drawn within 24 months of issuance in accordance with Internal Revenue Service (IRS) rules for arbitrage.

PWCS has significant flexibility regarding the projects to which the drawdowns can be applied due to language in the BOCS resolution that authorizes the bond issuance. It is PWCS general practice that VPSA bond drawdowns should be utilized for projects shown within the PWCS' 10-Year CIP. Drawdowns are approved by Director of Facilities and PWCS' Finance Department and subsequently routed to the County Finance Department for final approval. Debt issuances are scheduled to be drawn within 24 months of issuance in accordance with IRS rules.

Fieldwork was performed April 2019 through May 2019.

Objectives and Approach

The primary objective of this internal audit was to evaluate and assess whether the County is effectively managing certain elements of its General Obligation ("GO") bond issuance and draw process, including maximization of the County's debt capacity and related timing of expenditures. Our audit approach included:

Understanding and Documentation of the Process

This phase consisted primarily of inquiry, in an effort to obtain an understanding of the key personnel, risks, processes, and controls relevant to the objectives outlined above.

Evaluation of the Design and Effectiveness of Process and Controls

This phase included testing for compliance and internal controls of bond documents, invoices, drawdown requests, and other contractual compliance for both County and PWCS debt in our sample.

Reporting

Findings have been summarized into this report, and reviewed with the appropriate Management personnel.

The audit period for testing was July 1, 2013 through March 15, 2019.

Overall Summary / Highlights

The observations identified during our assessment are detailed within the pages that follow. We have assigned relative risk or value factors to each observation identified. Risk ratings are the evaluation of the severity of the concern and the potential impact on the operations of each item. There are many areas of risk to consider in determining the relative risk rating of an observation, including financial, operational, and/or compliance, as well as public perception or 'brand' risk.

Summary of Observation Ratings

(See page 3 for risk rating definitions)

	High	Moderate	Low
Debt Management	-	1	1

EXECUTIVE SUMMARY – CONTINUED

Observations Summary

Following is a summary of the observations noted in the areas reviewed. The detailed observations are included in the observations matrix section of the report. Definitions of the rating scale are included below.

Summary of Observations	
Observations	**Rating**
1. PWCS Changes to the Approved 10-Year CIP and Original Bond Draw Plan: Policy and Procedures, Supporting Documentation, Approval and Communication within PWCS and to the County	**Moderate**
2. Debt Capacity Monitoring: Benchmarks and Measures	**Low**

Provided below is the observation risk rating definitions for the detailed observations.

Observation Risk Rating Definitions	
Rating	**Explanation**
Low	Observation presents a low risk (i.e., impact on financial statements, internal control environment, brand, or business operations) to the organization for the topic reviewed and/or is of low importance to business success/achievement of goals.
Moderate	Observation presents a moderate risk (i.e., impact on financial statements, internal control environment, brand, or business operations) to the organization for the topic reviewed and/or is of moderate importance to business success/achievement of goals. Action should be in the near term.
High	Observation presents a high risk (i.e., impact on financial statements, internal control environment, brand, or business operations) to the organization for the topic reviewed and/or is of high importance to business success/achievement of goals. Action should be taken immediately.

BACKGROUND

Debt Management of Prince William County

The process of issuing debt by the County begins during the long-term budget planning process, through the Six-Year Capital Improvement Program ("CIP"). The CIP is adopted by the BOCS as part of the annual budget cycle. The CIP identifies the funding sources (i.e. bond proceeds, cash-to-capital, proffers, etc.) for each capital project. According to the CIP schedule, staff determine the optimal time to issue debt for capital projects based on cash flow needs and market considerations. Often, debt issuances are "bundled", if possible, to reduce issuance costs. The County Finance Department staff and Bond Counsel prepare draft bond documentation in advance of a planned bond sale. The County also works with Public Financial Management Company ("PFM") to set milestones and determine the sizing of the debt to be issued. PFM assesses the County's credit through an informal credit review prior to any meetings with the credit rating agencies (Moody's, S&P and Fitch). The BOCS then passes a resolution authorizing the issuance and sale of the bonds. The bonds are typically sold competitively on the open market or, in certain cases, in a negotiated sale with underwriters.

Bond proceeds are deposited into a designated SNAP bank account until spent. All drawdowns of bond proceeds are handled through the formal bond draw process whereby a Financial Analyst prepares the bond drawdown request, which includes documentation for all expenditures requested to be reimbursed by bond proceeds. The County's Debt Manager approves the drawdown request prior to seeking final approval from the County's Director of Finance. Director of Finance approval is required before bond proceeds can be drawn and moved from the SNAP account to the County's general operating cash account. The initial bond drawdown request normally includes allowable project costs incurred prior to the bond execution date. Proceeds are budgeted to be fully drawn down and, where possible, spent within 24 months of issuance in order to meet a possible exception to the general rule otherwise requiring the rebate to the US treasury of investment earnings in excess of the bond yield.

The County monitors its debt capacity using two metrics as defined in the BOCS adopted Principles of Sound Financial Management (PSFM):

- Annual Debt Service Payments as a Percentage of County Revenues
- Tax Supported Outstanding Debt as a Percentage of Assessed Value of Taxable Property

The Commonwealth of Virginia does not impose a legal limit on the amount of long-term indebtedness the County can incur or have outstanding. However, the County has adopted the following limits on its debt issuance: (1) The County's annual debt service expenditures cannot exceed 10% of annual revenues. Utilizing this metric, we have compared the County's ratio to those within the County's peer group (See Appendix A for benchmarking metrics used by the County in measuring debt capacity). According to balances pulled and utilized in the fiscal year ended 2018 Comprehensive Annual Financial Report ("CAFR") this percentage has remained steady between 7.1% - 8.3%. (2) The County's total outstanding debt principal must be less than 3% of total assessed value of taxable property. According to balances pulled and utilized in the fiscal year ended 2018 CAFR this percentage has remained steady between 1.6% - 1.9% (See Appendix A).

The following table shows the total debt issuances made by the County since fiscal year ended June 30, 2013 through 2018:

Debt Issuance	Fiscal Year Ended	Settlement Date	Issuance Amount
General Obligation 2013A	2014	7/31/2013	$ 31,158,569
General Obligation 2015A	2016	8/13/2016	67,944,728
IDA Revenue and Refunding of 2005 COPS	2016	4/5/2016	29,521,807
TOTAL			$ 128,625,104

BACKGROUND – CONTINUED

Debt Management of Prince William County Schools

The process of issuing School debt begins during the long-term budget planning process, through the PWCS 10-Year CIP, which is approved by the School Board prior to submission to the County for inclusion in the annual budget. The PWCS 10-Year CIP is based off enrollment forecasts and population growth within the County, which is derived from historical trends and current construction. The forecasts are disclosed within the 10-Year CIP and is published on PWCS' website annually. Once it is determined bond proceeds are needed for PWCS projects, the County Finance Department is notified and the County and PWCS Finance Departments work together to identify the proposed bond issuance amount. At this point, the process is nearly the same as the County's process. After debt needs are calculated, the County's Finance Department and Bond Counsel draft the bond documents. The County also works with PFM to set milestones and determine the sizing of the debt to be issued. PFM assesses the County's credit prior to any meetings with the credit rating agencies. The BOCS then passes a resolution authorizing the issuance and sale of the bonds. The bonds are typically sold competitively on the open market through VPSA or on a negotiated basis through underwriters.

Bond proceeds are deposited into a designated SNAP bank account pending disbursement. Drawdowns of debt proceeds by PWCS are based on the draw packets initially prepared by the PWCS' Facilities Planning Department and approved by PWCS' Facilities Planning and Finance Departments. Drawdown packets include a listing of all expenditures related to each drawdown along with a bond draw report and a bond draw letter. The bond draw report contains a listing of all bond drawdowns made on a specific bond issue through the requisition request date. In addition to tracking all prior requisitions, the drawdown report includes a listing of all expenditures and the applicable capital project in which the expenditures occurred as it relates to the requested drawdown of funds. The bond draw reports must be signed by the PWCS' Director of Facilities Planning prior to it being sent to PWCS' Finance Department. Next, the Facilities Planning Department prepares the bond drawdown letter. This letter outlines the total requested drawdown amount. This drawdown letter is approved and signed by the PWCS' Director of Financial Services who sends it to the County's Director of Finance for final approval.

School bonds are typically sold through the VPSA bond program. The BOCS resolution that authorizes the issuance and sale of school bonds contains language that allows for flexibility regarding the projects to which PWCS can apply bond proceeds. Once the BOCS approves the annual budget and appropriates funds, the PWCS may utilize the funds on other similar projects they deem necessary, without additional BOCS approval, regardless of whether or not the projects are listed in the Adopted CIP. A project not identified in the 10- Year CIP is approved by the Area Associate for Support Services and/or the Superintendent. Additional BOCS approval is only required for expenditures in excess of the annual appropriation. Once the drawdowns have been approved by PWCS' Facilities Planning and Finance Departments, the bond draw report and draw request are routed to the County's Director of Finance for final drawdown approval. All PWCS drawdown requests require the approval of the County's Director of Finance before they can be initiated. Proceeds are budgeted to be fully drawn down and spent within 24 months of issuance to maximize the possibility of qualifying for the two-year exception to the arbitrage rebate requirement under IRS regulations. Per the Code of Virginia, public school systems are not able to issue debt and must rely on their parent County or City to issue debt on their behalf as only incorporated governmental units have taxing authority.

The following table shows the total debt issuances related to PWCS since fiscal year ended June 30, 2013 through 2018:

Debt Issuance	Fiscal Year Ended	Settlement Date	Issuance Amount
VPSA Special Obligation	2014	7/31/2013	$ 67,775,731
VPSA Special Obligation	2015	10/7/2014	89,603,064
VPSA Special Obligation	2016	7/30/2015	106,171,707
VPSA Special Obligation	2016	4/27/2016	199,986,826
VPSA Special Obligation	2017	3/9/2017	83,729,734
VPSA Special Obligation	2018	5/24/2018	126,974,232
TOTAL			**$ 674,241,294**

OBJECTIVES AND APPROACH

Objectives

The primary objective of this internal audit was to evaluate and assess whether the County is effectively managing certain elements of its GO bond issuance process and proceeds draw activity, including maximization of the County's debt capacity and related timing of expenditures. The following areas were selected for this audit:

- Debt Management of Prince William County
- Debt Management of Prince William County Schools

Approach

Our audit approach was consistent with our internal audit methodology, which included the following phases:

Understanding and Documentation of the Process

The first phase of this audit consisted primarily of inquiry, in an effort to obtain an understanding of the key personnel, risks, processes, and controls relevant to the objectives outlined above. The following procedures were completed as a part of this phase:

- Obtained and reviewed bond documents for each area noted above;
- Reviewed relevant documented policies and procedures and any other relevant information;
- Conducted interviews with key personnel to identify relevant debt management processes; and
- Based on the information obtained through our inquiry procedures, we developed a risk-based work plan to validate the ongoing design and operating effectiveness of processes and controls.

Evaluation of the Design and Operative Effectiveness of Process and Controls

The purpose of this phase was to test compliance and internal controls based on our understanding of the processes obtained during the first phase. We utilized sampling and other auditing techniques to meet our audit objectives outlined above. We conducted the following testing, and other procedures as deemed necessary:

- Debt Management Prince William County:
  - Reviewed and identified key controls related to the debt management process;
  - Reviewed all debt full faith backed debt issuances made by County over last five fiscal years;
  - Tested all issuances to determine bond proceeds have been spent properly;
  - Traced all proceeds and draws to the Virginia SNAP statements;
  - Reviewed timeliness of expenditures and compared them to their applicable draw;
  - Reviewed and analyzed the County's debt capacity benchmarks;
- Debt Management Prince William County Schools;
  - Reviewed and identified key controls related to the debt management process;
  - Reviewed all debt full faith backed debt issuances made by PWCS over last five fiscal years;
  - Tested all issuances to determine bond proceeds have been spent properly;
  - Traced all proceeds and draws to the Virginia SNAP statements; and
  - Reviewed timeliness of expenditures and compared them to their applicable draw.

Reporting

At the conclusion of this audit, we summarized our findings into this report. We have reviewed the results with the appropriate Management personnel, and have incorporated Management's response into this report.

OBSERVATIONS MATRIX

Observation	1. PWCS Changes to the Approved 10-Year CIP and Original Bond Draw Plan: Policy and Procedures, Supporting Documentation, Approval and Communication within PWCS and to the County
Moderate	We noted there is not a documented process or procedure to monitor or assess changes made to the School's 10-Year CIP after the annual approval. Based on our review and inquiry with the PWCS Facilities Planning Department, it is not uncommon for the School's 10-Year CIP to change during the year. If a specific project is within the approved ten-year plan, the PWCS Facilities Planning Department has the ability and flexibility to push the start date of the project back and move another project within the approved ten-year plan forward. When these changes are made, they are reflected in the subsequent year's CIP that is submitted to the County with the Advertised Budget. It is PWCS general practice to only spend bond proceeds on projects that are listed in the approved 10-Year CIP. However, once the BOCS approves the annual budget and appropriates funds, the PWCS may utilize the funds on other projects they deem necessary to the extent the County and school resolutions and bond closing documents allow, without additional BOCS approval, regardless of whether or not the projects are listed in the adopted CIP. Having timely communication of changes to projects debt proceeds are being spent on is important to the overall County debt management process. It is understandable that given the nature of PWCS' projects that changes may have to be made and projects may be moved around based on actual experience of student growth, construction costs and construction progress. However, once the need for a change to the original CIP is determined, a documented procedure for how and why the change was made should be present. The original BOCS authorizing resolution contains the list of projects for which bond proceeds will be utilized, along with language that allows flexibility in the projects for which the bond proceeds can be applied. Since the CIP plan changes, the projects, which will be financed with bond proceeds, also change. Changes are reflected in the subsequent year's CIP plan, which is approved by the BOCS. While County Finance is able to see the changes to the CIP plan as the draw requests come in, changes are not readily identified per review of the draw request. There is no crosswalk between project codes and the project to decipher the changes from the previously approved CIP plan to the draw request. In 2018, a study was commissioned by PWCS titled "School Bond Sale Timing Analysis" in which the County provided input. PFM provided the study to the PWCS and the County quantifying the cost of carrying additional debt and not meeting drawdown timelines. For VPSA Series 2014-2018, PFM estimated the avoidable cost to be approximately $3.2 million. The lack of a documented, consistent, transparent process for determining the use of bond proceeds and the timing of projects within the 10-Year CIP could be considered a contributing factor for the County to be carrying the excess PWCS related debt.
Recommendation	We recommend PWCS develop formal procedures for documenting and communicating any change(s) made within the approved 10-Year CIP so that changes are communicated on a timely basis for transparency, not during the subsequent year's budget process, so that projects within the CIP can be tracked back to the projects included in the individual bond program. Additionally, we recommend PWCS develop a formal process for documenting what projects debt proceeds are being spent on as compared to the original BOCS authorizing resolution and to the 10-Year CIP, and provide such information to the County's Finance Department. We recommend the documentation include the project, amount, and reason as to why it is being moved in or out of the bond program. Additionally, the documentation should tie the project directly back to the 10-Year CIP. We understand the need for PWCS to have flexibility when utilizing debt proceeds for projects, and do not recommend removing such flexibility to determine project needs. However, once the need for change is determined, although not currently required, we recommend the process be documented within the 10-Year CIP on an ongoing basis and these changes to the CIP be communicated to all impacted parties within PWCS and the County.

OBSERVATIONS MATRIX – CONTINUED

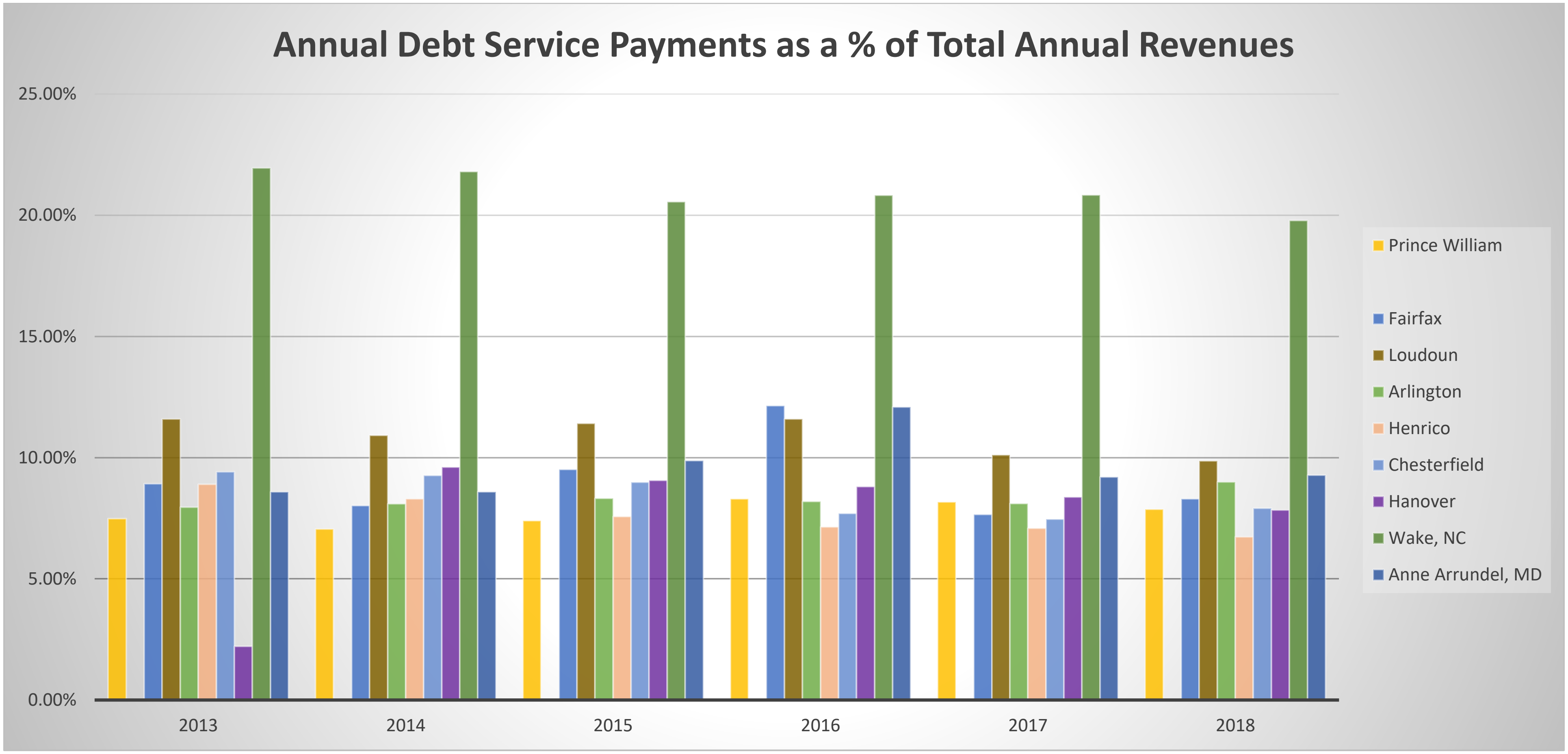
Observation	**1. PWCS Changes to the Approved 10-Year CIP and Original Bond Draw Plan: Policy and Procedures, Supporting Documentation, Approval and Communication within PWCS and to the County – continued**
Management's Action Plan	**Response:** Concur. Prior to this audit taking place, the Division engaged in research including the commissioning of the report that is cited in this audit (School Bond Sale Timing Analysis) and spend down analysis. This research was delivered in October of 2018. The Division has also been working with County staff on this issue and continues to have discussions related to bond proceeds. As a result, we have put controls in place related to the accounting for bond proceeds with more changes coming in the next several months. Additionally, the approval and hiring of a CIP accountant, approved in the FY 2019 budget process, who will report to the Division's Office of Financial Services has taken place. This position will be responsible for all facets of CIP management, project accounting, and other debt related issues. The Division has also put in place the ability for County staff to review all transactions related to debt. This inquiry access to the School Division's financial management system will address many of the reporting issues raised by the auditors. County staff will be able to review transactions by bond issue, as they happen. Again, much of this work was performed prior to the beginning of this audit. We disagree, however, that a "reporting process requiring documentation that includes the project, amount, and reason as to why it is being moved in or out of the bond program" is necessary or appropriate. As you are aware, the legal authority to determine how appropriated funds may be spent solely lies with the School Board, subject only to expenditure within any specified classifications. We will further modify existing accounting/budget structures so that one may identify if a transaction related to debt was associated to a project originally included in the bond application. We may make other chart of account changes based on conversations with the County staff. Finally, the Division will be collaborating with the County regarding the issue of the bond resolutions the County Board and School Board approve prior to the sale of debt, ensuring the language is better aligned with the bond application that the Division submits to the Virginia Public School Authority prior to the sale of debt. **Responsible Party:** PWCS Finance **Estimated Completion Date:** To Be Determined

OBSERVATIONS MATRIX – CONTINUED

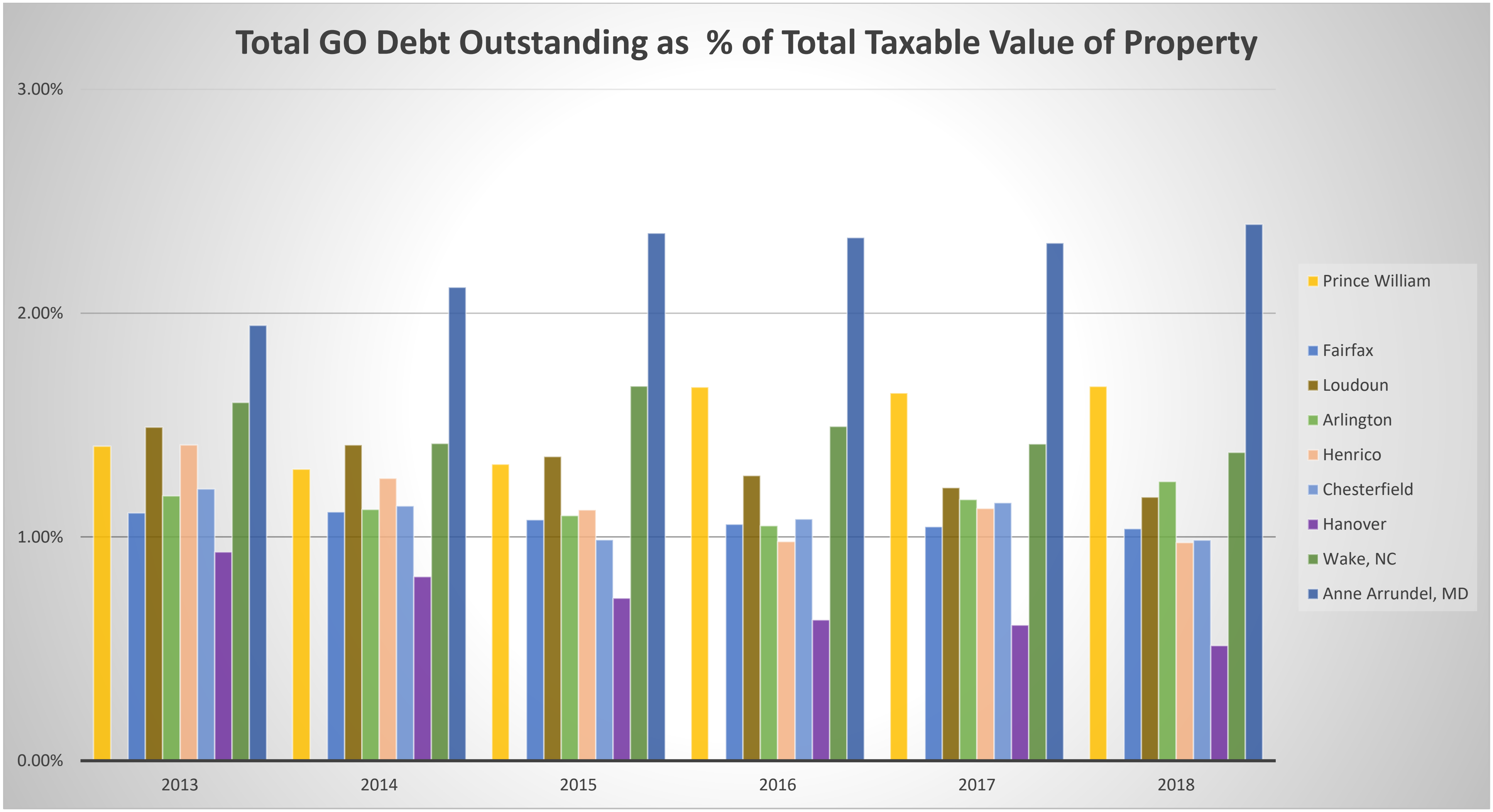
Observation	2. Debt Capacity Monitoring: Benchmarks and Measures
Low	Through discussions with County personnel, we noted that the County is currently only measuring its capacity for carrying debt using two benchmarks: annual debt service / total annual revenues and total debt outstanding / total taxable value (See Appendix A for current reported benchmarks). These benchmarks are disclosed in the CAFR, but it would be beneficial for the County to measure its capacity for carrying debt using many different benchmarks rather than just two. This would allow the County to compare itself to its peer group using many different metrics to see how the County truly compares to its peer groups when it comes to carrying and issuing debt related to capital projects. The County obtains a credit assessment review from PFM periodically. These reviews include significant amounts of benchmarking and other information from the point of view from the three primary credit rating agencies, Moody's, S&P, & Fitch. Additionally, these reports provide 5-year outlooks based on local and national market data. PFM provides these reviews when the County is assessing the possibility of issuing new debt or refunding current debt. Tracking its debt capacity by as many benchmarks as possible would allow the County to see a more complete picture to compare to Counties within its peer group. Also, there are metrics the County can use to track debt that would allow the County to track its debt capacity in comparison with Counties that are not only in the peer group but are located next to the County geographically as well.
Recommendation	We recommend that the County begin to utilize multiple different benchmarks, including those provided by PFM for measuring its debt capacity rather than the two currently being utilized. This will provide the County with more relevant information as it not only relates to other counties' within the County's peer group, but also with all counties' including those that are geographically very close to Prince William County. We believe that if the County adopts multiple benchmarks it will allow the County to quickly compare itself to its peers and provide the most relevant data when making decisions regarding issuing debt (See Appendix B for additional benchmarks). The most relevant benchmarks are already provided periodically by PFM. We suggest the County obtain a PFM credit assessment review annually to better assist in making debt-related decisions during the annual budgeting and future planning processes.
Management's Action Plan	**Response**: Concur. The County currently receives a credit assessment review from PFM on an annual basis and benchmarks the various metrics against a peer group of other triple-AAA jurisdictions. This information is published in the County's annual Fiscal Health Outlook Report and shared with the BOCS. The PSFM requires County staff to review the document annually and review it with BOCS at a minimum every four years, in conjunction with the term of the Board. As such, the County's Finance Department, in consultation with PFM, is in the process of reviewing the PSFM to determine if additional metrics related to debt management should be recommended to the BOCS for adoption. **Responsible Party:** County Director of Finance **Estimated Completion Date:** On-going

APPENDIX A

The Commonwealth of Virginia does not impose a legal limit on the amount of long-term indebtedness the County can incur or have outstanding. However, the County has adopted the following debt limits: (1) The County's annual debt service expenditures cannot exceed 10% of annual revenues, and (2) The County's total outstanding debt principal must be less than 3% of total assessed value of taxable property. According to balances pulled and utilized in the fiscal year ended June 30, 2018 CAFR this percentage has remained steady between 1.6% - 1.9%. See below for tracking of the metrics currently being used by the County and how they compare to the County's peer group over the previous five fiscal years (fiscal years ending June 30, 2013 through 2018). The County's peer group was pulled from the County's fiscal health report and all data gathered was extracted directly from the published CAFRS on each County's' website. See below for tracking of metrics:



APPENDIX A – CONTINUED

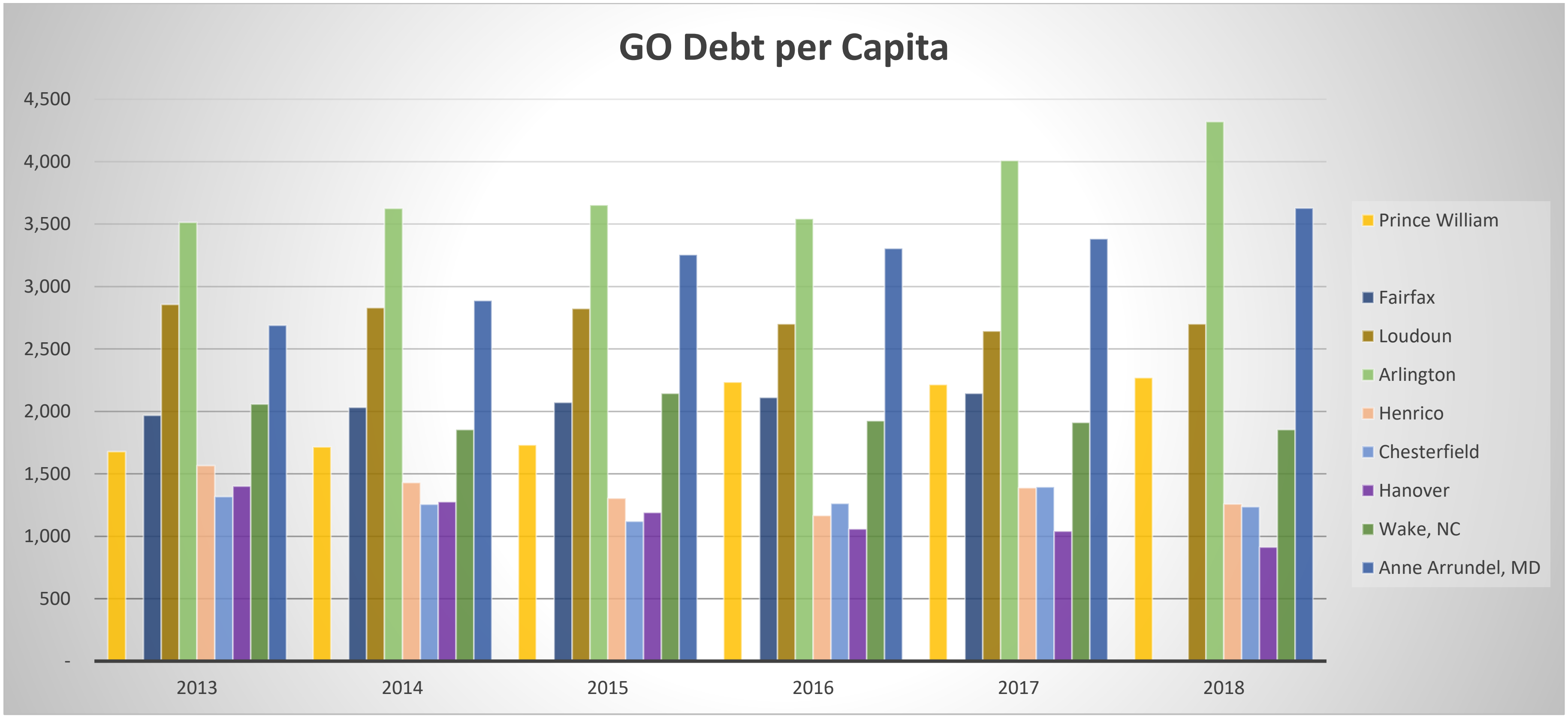


APPENDIX B

Based on RSM's review of the metrics being employed by Prince William County to measure debt capacity, we recommend that the County adopt several additional benchmarking methodologies. These methodologies include the following:

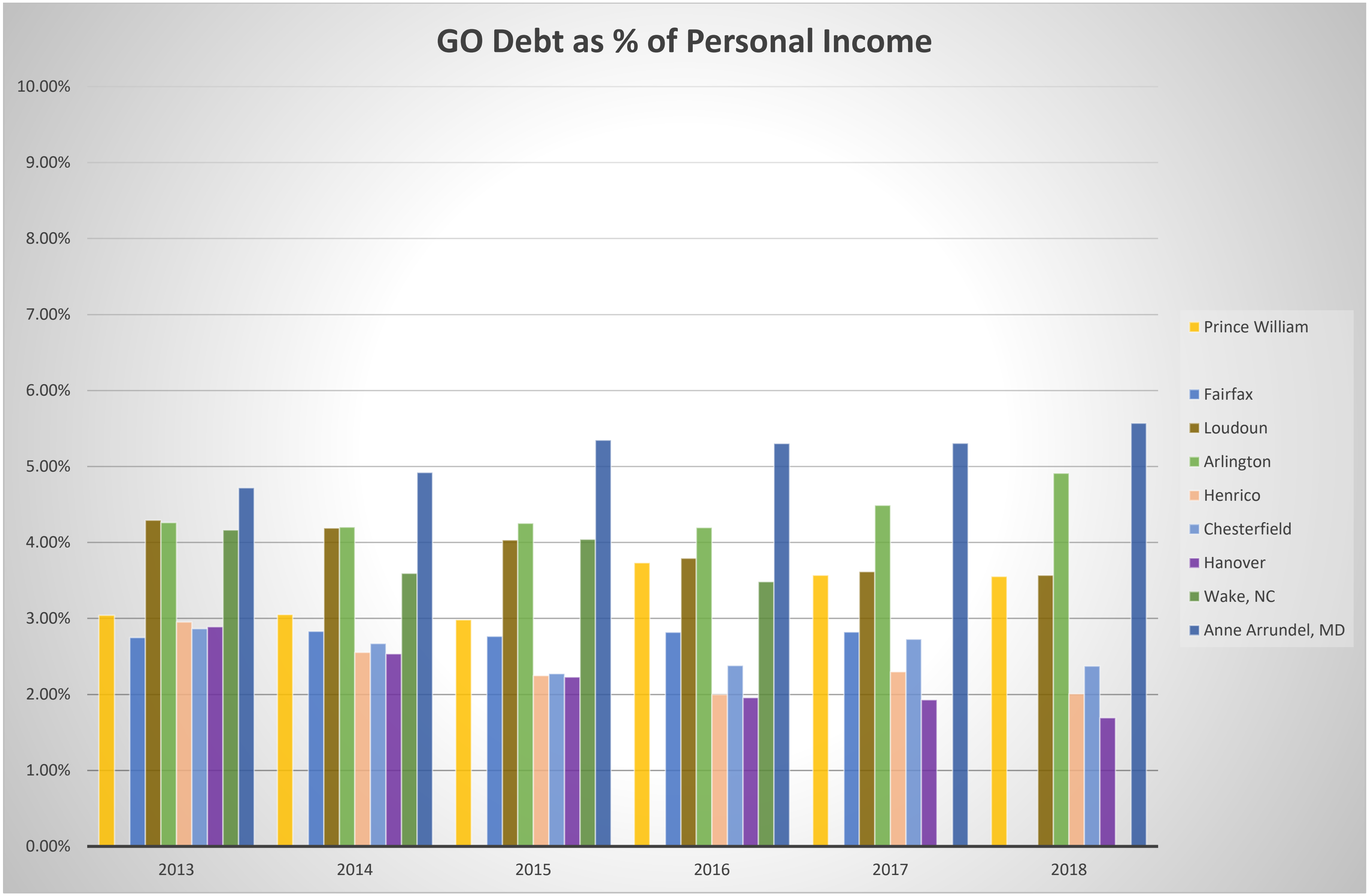
- GO Debt per Capita
- GO Debt over the Increase in population
- GO Debt as a Percentage of Personal Income
- Debt Service Expenditures as a Percentage of Total General Expenditures

RSM prepared the tracking of the benchmarks listed above on behalf of the County and its peer group. Each benchmark includes the previous five fiscal years of date (fiscal years ending June 30, 2013 through 2018). The County's peer group was pulled from the County's fiscal health report and all data gathered was extracted directly from the published CAFRs on each County's website.

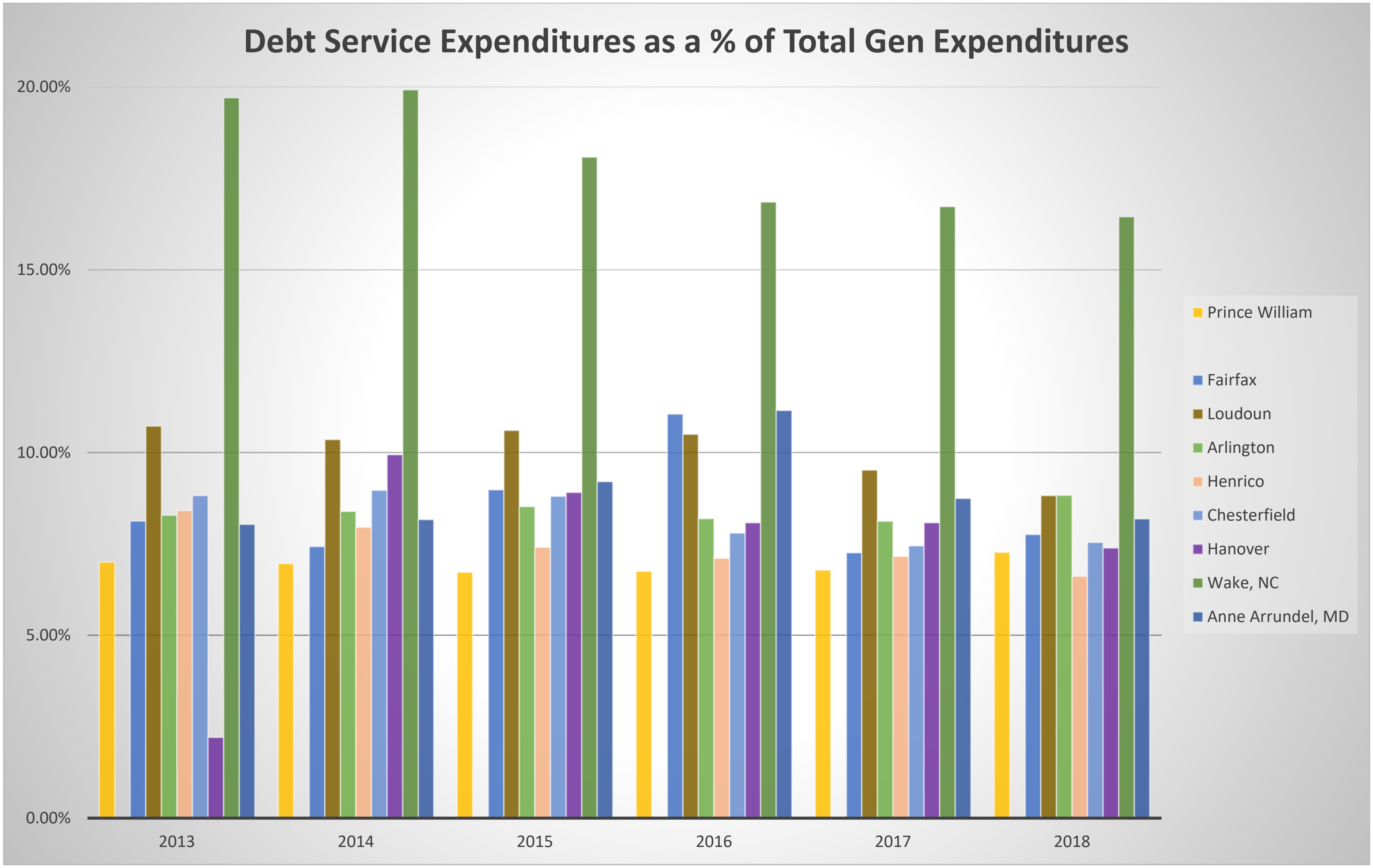


Appendix C – Continued

APPENDIX C – CONTINUED



APPENDIX C – CONTINUED



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