

SOUND TRANSIT AUDIT AND REPORTING COMMITTEE MEETING

Summary Minutes

January 23, 2014

CALL TO ORDER

The meeting was called to order at 10:34 a.m. by Committee Chair Dave Enslow, in the Ruth Fisher Boardroom, 401 South Jackson Street, Seattle, Washington.

ROLL CALL

Chair

(P) *Dave Enslow, Sumner Mayor*

Vice Chair

(A) *Larry Phillips, King County Council Chair*

Committee Members

(P) *Fred Butler, Issaquah Mayor*

(P) *Mary Moss, Lakewood Councilmember*

(A) *Dow Constantine, King County Executive*

(P) *Josh Benaloh, Citizen Oversight Panel Chair*

(A) *John Marchione, Redmond Mayor*

Ms. Katie Flores, Board Coordinator, announced that a quorum of the Committee was present at roll call.

REPORT OF THE CHAIR

Brian McCartan, Executive Director of Finance and Information Technology reviewed the agenda.

BUSINESS ITEM

Minutes of the September 26, 2013 Audit and Reporting Committee Meeting

It was moved by Boardmember Moss, seconded by Boardmember Butler, and carried by the unanimous vote of all members present that the minutes of the September 26, 2013 Audit and Reporting Committee be approved as presented.

EXTERNAL AUDITS

Final 2012 Reports

Kelly Priestly, Director of Accounting, presented the remaining two reports from the 2012 financial reporting period. The reports include the Agreed Upon Procedures for National Transit Database Reporting and the 2012 Accountability Audit report from the State Auditor's Office.

Agreed Upon Procedures – National Transit Database Reporting

The National Transit Database (NTD) was established to be the primary source for information statistics on transit systems. 750 transit providers currently report through NTD. The data is used by congress in making funding and policy decisions. The audit report is an agreed upon procedure specified by the Federal Transit Administration. Under the agreed upon procedures, the auditors review all the financial forms submitted to NTD by Sound Transit. There were no findings in the report issued by the auditors.

SAO Accountability Audit

The audit exit conference with the State Auditor's Office (SAO) occurred in December 2013. The SAO report includes an evaluation of internal agency controls and performs audit procedures to determine compliance with state laws and SAO procedures. The report showed that internal controls were adequate to safeguard public assets, the agency has complied with state laws and regulations and its own policies and procedures in the areas examined.

There was a finding in the prior year and Sound Transit has remediated that issue in 2012. The report showed a clean audit for 2012.

2013 Subarea Procedures

Ms. Priestly noted that the 2013 Subarea Procedures are audited by Sound Transit's contracted auditor. The auditor uses agreed upon procedures developed by the agency in consultation with the Sound Transit Citizen Oversight Panel. The procedures remain mostly unchanged from the prior year.

Sound Transit and the Citizen Oversight Panel supported the addition of a \$100,000 threshold for reporting findings. The recommendation would eliminate the need to report small findings and limit reporting to findings that would be significant to the Audit and Reporting Committee. Ms. Priestly noted that most prior errors have been around \$5,000, and there have been a couple errors related to an incorrect calculation or rounding error that would meet the \$100,000 threshold if similar errors occurred again. The procedure could be modified to add a cumulative threshold as well.

The Committee supported the addition of a \$100,000 threshold for a single exception, and a cumulative threshold of \$250,000 for the audit period. Ms. Priestly noted that the Committee's recommendation will be incorporated into the procedures.

2013 Financial and Federal Audit Plan (KPMG)

Karissa Marker, Audit Engagement Partner, and Michael Ortman, Audit Manager, from KPMG reviewed the 2013 Financial and Federal Audit Plan. Ms. Marker reviewed KPMG's responsibilities for conducting the audit. The audit objective is to issue an opinion on Sound Transit's financial statements, and provide an assurance that the statements are free from material misstatement based on the accumulation of sufficient appropriate audit evidence. The audit will focus on areas of materiality. Areas of responsibility were reviewed for each party. The deliverables will include the financial statement audit, the single audit of federal grants, and agreed on procedures for subarea and national transit database reporting. Findings on internal controls or business efficiencies will be included in a management letter. The audit will also review whether there are audit adjustments, or accounting policy changes. KPMG will also complete a stand-alone ORCA audit report.

In 2013, significant fixed asset changes occurred, including land and easement exchanges with the University of Washington, the purchase of the last Sound Sounder easement from BNSF, and the purchase of 19 new buses for ST Express. The audit will also review significant accounts and transactions and significant estimates and disclosures. Significant accounts and transactions include capital assets, revenue generation, investments and interest income, federal funding and compliance, transactions with other governments, and long term debt. Significant estimates and disclosures include construction claim liability, valuation of investments, accounting for land swaps, overhead allocation, and capturing and presenting expenses. KPMG will also consider fraud risks, and will evaluate audit risks based on a matrix comparing the significance and likelihood of a risk occurring.

In addition to auditing the financial statements, KPMG will also conduct a single audit, or A133 audit to review federal grant funding. The single audit will review financial statements and reporting on the expenditure of federal awards as well as a compliance audit on federal awards during the fiscal year.

The audit timeline was reviewed, preliminary field work has been completed and KPMG expects to begin auditing in March and issue the audit report in May 2014 in time for the June 2014 Audit and Reporting Committee meeting.

FINANCIAL REPORTING

Overview of 3Q 2013 Financial Results and Reports

Pete Rogness, Director of Budget and Financial Planning, gave a report on the third quarter 2013 Financial Results and Reports.

Revenues through the third quarter are \$7 million over the budget. Sales tax, Rental Car Tax and Motor Vehicle Excise Tax are all around 3% above budget. Fare revenues were 10% above budget. Sounder revenues were 6% above budget, ST Express was 10% above budget, and Central Link was 5% above budget. Investment income was below budget due to the mark to market entry that will be discussed in more detail later. Miscellaneous revenues were 10% ahead of budget. Federal Grants were below budget by \$5 million because of lower drawdowns for the South 200th Link Extension and Mukilteo Sounder Station project. Local and State contributions are ahead of budget because of \$549,000 received from the state for the Sounder wayside power for the Lakewood Layover Project.

Total fare revenue was 10% above budget for transit operations. Boardings on all transit modes were ahead of budget forecasts and 2012 boardings except for Tacoma Link. The fare box recovery rate exceeded the annual target for all the modes. Transit operations expenses were 94% of the annual budget. Sounder was 91% of budget because of vehicle maintenance with Amtrak being lower than budgeted. ST Express was at 96% of the budget due to lower partner rates than budgeted and lower on-call and unscheduled facility maintenance that was budgeted but not needed. Tacoma Link was at 90% of the budget, due to services being at 73% of the budget because of in-house training. Central Link was at 93% of its budget because Sound Transit received the insurance payment for costs related to copper wire replacement, and lower costs for maintenance.

All departments are within budget, salary and benefits were within their budgets, with the exception of the non-departmental category because of depreciation. Salaries and benefits were at 98% of the budget, and there were savings in the services area, including interlocal agreements, legal services, software and hardware, auditing services, and temporary services. The agency had a 9% position vacancy rate, there were 58 vacancies at the end of the third quarter. Two positions were added in the Executive Department, a position to support the rail activation program and a term-limited position in Board Administration.

Capital expenditures for ST Express are at 65% of the budget. Budget savings are due to savings in the Totem Lake Freeway Station and 85th Street corridor, there were also schedule delays with the ST Express bus base, the I-90 Stage 3 project and the Mountlake Terrace Freeway Station projects. Capital expenditures for Sounder are below budget because of savings with the Layover project. Capital expenditures for Central Link are below the year to date budget because of funding that was not needed for the University Link project budget. The South 200th Link Extension is ahead of the budget schedule because a design-build contract was utilized for the project. Other link extensions are trending behind budget schedules except for the Northgate Link Extension which is \$4.6 million ahead of the scheduled budget. There were eight projects that weren't started in 2013 that were anticipated, including Positive Train Control. There are schedule delays with the ST Express fleet replacement program and Sounder vehicle overhaul program.

3Q Asset Liability Management Report

Jim Block, Cash Investment Administrator, gave a presentation on the third quarter report.

There were no changes to the stoplight indicators in the asset liability management report. The federal government will keep the Fed rate floating between 0 and 25 basis points for a significant period. In the third quarter 2013, the average yield on total cash and investment holdings increased two basis points, to 90 basis points. The state investment pool was at 12 basis points at the end of the third quarter and the King County investment pool was at 47 basis points. There has been no change in investment strategy and there were no investment purchases in the unrestricted portfolio in the third quarter. Yields in longer term bonds remained higher resulting in continued unrealized losses due to the mark to market adjustments. Actual interest earnings without the fair market value adjustment were \$6 million, or \$1.8 million over budget (without the mark to market losses). Since Sound Transit plans to hold the investments to maturity, the agency will not realize a loss. Performance returns are above the benchmark for the unrestricted portfolio but below the benchmark for capital replacement portfolio due to the increase in longer term yields. All portfolios are in compliance with policy limits and guidelines. Tax exempt debt is higher than taxable debt. The current borrowing rate for short-term debt is around 61 basis points and the current borrowing rate for long-term debt is around 4.3%.

Mr. McCartan provided an update on Sound Transit's position with a lease-leaseback transaction that was guaranteed by AIG. In the economic downturn AIG's credit rating was downgraded below the required rating threshold for the transaction. Sound Transit has not found a replacement for AIG in their role as guarantor.

Contract Reports

Ted Lucas, Director of Procurements and Contracts, reviewed the four contract reports included in Boardmember packets: a report covering 3rd quarter contracts awarded by the CEO that are between \$100,000 and \$200,000; a report covering 3rd Quarter sole source and propriety contracts awarded by the CEO that are between \$10,000 and \$100,000; a report covering 3rd Quarter proprietary contracts awarded by the CEO that exceed \$100,000; and all open contracts in excess of \$10,000 that were still current in the 3rd Quarter.

The first three reports are required under the Board's procurement policy, Resolution No. R78-2. The report showing all open contract contracts over \$10,000 that were still current in the 3rd quarter is included for the Committee's information.

SELECTION OF A 2014 PERFORMANCE AUDIT TOPIC

Chair Enslow noted that the Committee is scheduled to select an audit topic for the 2014 Performance Audit. The Committee began discussing potential audit topics at the September 26, 2013 Audit and Reporting Committee meeting.

David Hammond, Internal Audit Director, provided a brief overview on each of the potential topics. The four potential topics are Central Link Operating Costs, Sound Transit's Security Program, the Sound Transit Phase Gate Program and Information Technology Project Management. Sound Transit's Performance Audit program requires a performance audit in years the State Auditor's office does not perform an audit of Sound Transit. Mr. Hammond noted that the State Auditor's office does not plan to perform a performance audit on Sound Transit in 2014 or 2015.

Mr. Hammond identified Central Link Operating Costs and Sound Transit's Security Program as the highest ranked performance audit topics based on feedback and further research. The other two topics; Sound Transit Phase Gate Program and Information Technology Project Management are both on the internal audit plan for 2014 if there are not selected by the Audit and Reporting Committee as the 2014 topic.

The potential audit topics were evaluated based on the potential for cost savings, the potential to improve performance and efficiency, the potential to facilitate decision-making, the potential to contribute to public accountability.

Central Link Operations is a \$60 million program, with costs primarily based on service levels. The audit would be based on the current business model that utilizes outside operators for Link service. The audit would use peer benchmarking available through the National Transit Database. Mr. Hammond noted that this audit may be more effective when the link operating system matures.

An audit of Sound Transit's Security Program would look at efficiencies to the existing program. The annual budget for Sound Transit security is around \$18 million. Internal benchmarking work was recently presented to the Operations and Administration Committee meeting on December 5, 2013. Security costs are largely driven by the Central Link program. The benchmarking analysis showed that Sound Transit's program is sufficient based on crime rates, and efficient based on comparisons to peers. The performance audit would go beyond the internal benchmarking work that was done, and look at unique differences between Sound Transit and peers. The audit could identify the need to revisit risk assessments, fare enforcement deployment, alternate methods to secure facilities, and enhancing technology and partnering options.

Committee members spoke in favor of a performance audit on Sound Transit's Security Program based on the program cost and potential for cost savings. The Committee asked that the audit take a comprehensive look at the all of different aspects that make up the security program. Committee members felt that an audit of the Central Link Operating Costs may be premature. Mr. Benaloh, COP Chair noted that the Citizen Oversight Panel also favored the Security Program as the 2014 performance audit topic.

It was moved by Boardmember Butler, seconded by Boardmember Moss, and carried by unanimous vote that the Security Program be selected as the 2014 performance audit topic.

INTERNAL AUDIT UPDATE

Construction Change Order Audit Report (Moss Adams)

Curtis Matthews, Lead Auditor, and Jeff Witt, Senior Manager, from Moss Adams presented the Change Order Performance Audit. The audit was conducted in compliance with Generally Accepted Government Audit Standards so that it is a true performance audit, not a compliance audit. Mr. Matthews reviewed the audit objectives; to determine that amounts charged for change orders were the responsibility of Sound Transit, not based on design deficiencies or contractor errors, that change orders had necessary support and pricing detail, that change orders were not due to compliant use of contingency or other set-asides, and reviewed change order cause and cost analysis procedures.

Eighty change orders were selected for review totaling over \$19 million. The audit found that Sound Transit's policies and procedures and manuals were very good. The auditors complimented Sound Transit on its detailed procedures and efforts at improvement, including undertaking a Kaizen business improvement analysis of the change order process. Sound Transit also uses a cross-functional change control board, a best practice. The parts of the organization impacted by the change are able to weigh in and determine whether the change can take place. In addition, Sound Transit has established a round table forum to discuss General Contract/Construction Manager contracts best practices and lessons learned. Sound Transit uses independent cost estimates to verify cost and pricing data and have used detailed cost analysis for each change order that incorporated cost comparisons between independent cost estimates, the contractor proposed price and the final negotiated price. Sound Transit contracts establish the response time for requests for information, contractor change notices, and agency approval or denial of requests for change.

The auditors identified four areas to improve Sound Transit's change order program. The recommendations include implementing additional controls and policies related to monitoring and managing schedules on interconnecting projects; applying change order controls to increase the timeliness of pursuing errors and omissions, contractor performance failures or construction damage related cost recoveries; ensuring duplicate change order amounts are eliminated on a timely basis; and evaluating and implementing additional controls to ensure change orders are adequately supported with cost estimates prepared by the contractor. Related to the second recommendation, the audit found three change orders related to errors and omissions or contractor performance errors identified by Sound Transit that were not addressed in a timely way. The agency's practice is to wait until later in the process to address the issue because of insurance claims being involved. If the agency wishes to continue this practice, the audit recommends applying a level of materiality. Ahmad Fazel, Executive Director of Design, Engineering and Construction Management noted that in cases where Sound Transit identifies a change order as a design error and omission by the contractor, the agency practice is to wait until more is known. Sound Transit then pursues claims for errors or omissions from the contractor.

Internal Audit Reports Issued

Shelli Applegate, Senior Internal Auditor, reviewed the Wireless Device Program Audit recently completed by the internal audit team. The audit report with the management response was issued on December 30, 2013. Sound Transit spent \$340 thousand in 2013 for wireless devices and usage, including 400 cell phones used by employees and partner agency staff, and wireless internet access devices on buses and trains. In August 2012, the policy for acquisition and use of mobile phones was revised. The older policy used to allow personal use that was reimbursed by employees, but the new policy does not allow personal use. Information Technology has established new procedures to support the revised policy and continue to explore new devices and services to best serve the agency.

The audit found opportunities for improvement and had one finding—that internal controls need to be improved. The audit recommendations include ensuring that all the documentation is completed, approved and maintained. Procedures also need to be established to review wireless device billings, periodically review business justifications and manage returned and unused devices. Management agrees with the recommendations and has developed an action plan. A follow-up audit will be completed next year to determine if the actions implemented are effective.

Awet Habtemariam, Senior Internal Auditor, reviewed the memo issued to management on the 2011 Value Engineering performance audit follow-up. The Value Engineering audit was issued on March 22, 2012 and had 85 recommendations. Twenty of the recommendations included procurement and contract language changes that have not yet been implemented. The follow-up audit showed that 56 of the 65 remaining recommendations were fully addressed, four other recommendations were substantially addressed. Five of the recommendations were not yet implemented. The audit follow-up had four observations—Operations personnel must be more involved with future value engineering efforts, the value engineering plan would benefit from more formal documentation and approval, an annual value engineering report should be developed, and value engineering efforts could be improved if participants are provided with additional cost information prior to workshops.

From the four observations, four recommendations were made—that the DECM department continue to support the Operations department's development of staff to support value engineering efforts, to formalize the annual program plan review process, develop an annual program report, and continue development of pre-workshop information.

Mr. Hammond reviewed the Motor Vehicle Excise Tax Audit. Phase one of the audit was issued in 2011, and a follow-up report has now been completed. Phase two of the audit, to evaluate the motor vehicle excise tax accuracy, has also been completed. All the recommendations from the first phase of the audit have been addressed. Phase two of the audit found inconsistent application of Department of Licensing policies and procedures that negatively impacted the collection of the Motor Vehicle Excise Tax. The

taxation in effect is highly accurate, the audit seeks to improve accuracy in a couple focused areas. Management will work on the areas identified by the audit and another phase will be undertaken in the future.

Prior Recommendation Status

Mr. Hammond reviewed the follow-up status for all prior internal audits.

Internal Audits in progress

Mr. Hammond noted that seven audits are currently in progress; Partner costs, Paratransit follow-up, Downtown Seattle Transit Tunnel follow-up, Fuel Purchasing follow-up, Ridership Reporting follow-up, Performance Metrics, and annual recurring areas such as travel expenses and procurement cards.

NEXT MEETING

March 27, 2013
10:30 a.m. to 12:30 p.m.
Ruth Fisher Boardroom

ADJOURN

The meeting was adjourned at 12:34 p.m.



Larry Phillips
Audit and Reporting Committee Chair

ATTEST:



Katie Flores
Board Coordinator

APPROVED on March 27, 2014 KWF