

## **SOUND TRANSIT AUDIT AND REPORTING COMMITTEE MEETING**

Summary Minutes  
June 16, 2016

### **CALL TO ORDER**

The meeting was called to order at 11:08 a.m. by Committee Chair Rob Johnson, in the Ruth Fisher Boardroom, 401 South Jackson Street, Seattle, Washington.

### **ROLL CALL**

Chair

(P) Rob Johnson, Seattle Councilmember

Vice Chair

(P) Dave Enslow, Sumner Mayor

Committee Members

(A) Nancy Backus, Auburn Mayor

(A) Joe McDermott, King County Councilmember

(P) Mary Moss, Lakewood Councilmember

(A) Dave Somers, Snohomish County Executive

(P) Philip Lovell, Citizen Oversight Panel Chair

Ms. Linda Markey, Board Coordinator, announced that there was not a quorum of the Committee present at roll call. Committee Chair Johnson noted that a quorum was expected, so the committee would hear reports first and move to Business Items after an additional member arrives to establish a quorum.

### **REPORT OF THE CHAIR**

Committee Chair Johnson noted that the agenda includes updates from both internal and external audit, and a review of first quarter financials. He also noted that there would be an executive session.

### **EXTERNAL AUDIT RESULTS**

#### Auditor Report on the 2015 Financial, Federal, and Agreed Upon Procedure Audits - KPMG

Kelly Priestly, Director of Accounting introduced the KPMG audit engagement team to provide a report on its audit of Sound Transit's 2015 financial statements. KPMG's Karissa Marker introduced the KPMG engagement team and noted that many team members assisted in the previous audit as well as small business Francis and Company. KPMG's presentation included a review of audit deliverables: an opinion on financial statements; a Single Audit Report; and three Agreed upon Procedures letters, the audit process, results and findings. The three letters pertain to subarea equity, the national transit database and green bonds. Additional communications deliverables include planning and year-end results briefings and a letter of required communications to the Audit and Reporting Committee.

Ms. Marker explained that the audit took a risk-based approach beginning with an understanding of the risks of the enterprise followed by a critical review of policies and processes in key areas and evaluation of significant account balances.

Chair Johnson recognized the arrival of Boardmember Enslow.

Ms. Marker continued with a summary of the Auditor's Responsibility under generally accepted auditing standards (GAAS). Responsibilities include providing reasonable assurance that the financial statements of Sound Transit are free of material misstatement and obtaining sufficient understanding of internal controls to plan the audit and determine the nature, timing and extent of performed procedures. Ms. Marker further clarified that understanding of internal controls would inform the audit but would not result in an issued opinion on internal controls.

The audit found no material errors, irregularities or illegal acts. As a result, KPMG issued an unmodified opinion dated May 26, 2016 stating that the Sound Transit financial statements are presented fairly, in all material respects, in accordance with generally accepted accounting principles (GAAP).

In order to inform the Audit and Reporting Committee, the audit highlighted three changes in significant accounting policies and methods. First, the agency issued additional debt of \$943M, a portion of which was in "Green Bonds". This is a new category in the market and for Sound Transit. Second, the agency implemented a new overhead allocation process. The audit confirmed that staff used a thorough process to evaluate and identify the need for the new process and concluded that the change is appropriate. Finally, the agency reclassified the Capital Replacement Fund from current to noncurrent. This reclassification more appropriately reflects the long-term nature of the fund.

The audit also reviewed the process used by management in forming accounting estimates and the reasonableness of those estimates in three areas. The assessment of construction claims and the process that management uses to set those reserves is reasonable and appropriate under accounting standards. There was no change in the process for valuation of investments and the audit found that this process and methodologies continue to be reasonable and the audit agrees with the output of those processes. Finally, the audit looked at detailed calculations of allocated overhead costs and found the process change to be reasonable. The audit did not find any significant audit adjustments. Further, the audit found no significant deficiencies or material weaknesses and there were no passed adjustments or disagreements with management. Ms. Marker noted that KPMG is independent of Sound Transit.

Michael Ortman continued with a summary of the Single Audit Report and Agreed upon Procedures Reports results. The Single Audit Report reviewed agency compliance with grant requirements for federal funds received and specifically reviewed Federal Transit Cluster program that accounts for the bulk of federal dollars received by Sound Transit. KPMG issued an unmodified audit opinion with no reportable findings on May 26, 2016.

KMPG issued the first of the Agreed upon Procedures Reports, the National Transit Database (NTD) as required by the Federal Transit Administration (FTA). This report relates to the original submission of information to the NTD, not the final submission. The report includes three insignificant findings that are included in the report only to inform the Committee. Sound Transit has corrected or is correcting these findings for inclusion in the final submission. Two of the findings related to variances in mileage statistics. The third relates to the completion of a statistician's review of some of the sampling procedures. This is standard practice when sampling is used. At the time of the report, Central Link was pending this review and approval of the methodology used but is now complete.

Boardmember Enslow asked for clarification on how KMPG determines when to spend additional time investigating variances. KMPG responded that in this type of audit, auditors perform exact procedures and in this instance did not require additional time. They identified a variance in numbers and reported the variance to staff for correction.

Sound Transit, the Citizen's Oversight Panel (COP) and KPMG worked together to determine appropriate steps to test the allocation balances to each subarea based on pre-determined rules to inform the subarea report. Test work has completed and results are under review. There are currently no reportable findings.

KMPG and staff developed steps to test whether proceeds from the 2015 Green Bond Issuance were appropriately allocated to eligible Green Bond projects. Test work is complete and results are under review. There are currently no reportable findings. A consultant's report that defines what green items would be applicable is associated with the bond document. The process and intent of the procedures performed related to the dollar amounts agreeing with the underlying books and records of the organization and that KMPG could sample and agree that those items were appropriately rolling up.

Mr. Ortman continued with a status of the financial statement audit over ORCA financials. Audit test work completed in March and KPMG issued a non-modified opinion on April 15, 2016. Those results have been presented to the Joint ORCA Board. Ms. Priestly clarified that the report is not a Sound Transit report but is presented to keep the committee informed of completed work as part of Sound Transit's responsibilities as a fiscal agent to the other participating agencies. Each agency selects their portion of assets and liabilities coming out of the ORCA system.

KPMG completed their presentation and noted that audit committee members interested in additional access to webcasts or meetings would find information in their packets along with an appendix detailing procedures.

## Management Report on 2015 Audited Results

Ms. Priestly began with additional context and background on the External Audit reports. Within the financial statements and the Single Audit Report, there are four major elements. Management adds a statement of their responsibility for the financial statements as well as their discussion and analysis. The auditor's results provide the third element of the report and the final section contains the financial statements along with notes. The notes include specific accounting policies to provide information about decisions made by management in applying GAAP. While all financials comply with GAAP, the notes include specific accounting policies that provide information about options and choices made by management in applying GAAP. The notes also include disclosures on agency significant commitments and contingencies. Ms. Priestly then summarized highlights and changes from last year.

The FTA eligible cost allocation plan and indirect cost rate proposal, approved in September 2015 and implemented in 2015, leveraged the federal plan to charge costs to operations, resulting in \$14.8M more in costs capitalized in 2015. The King County Investment Pool changed from cash to investments and the Capital Replacement fund changed from current to long-term. Ms. Priestly explained that the Board adopted a change to the capital replacement fund to set aside approximately \$300M to assist in meeting long term system maintenance "state of good repair" needs. The Board may use this emergency reserve at their discretion. Mr. McCartan explained that the agency forecasts and reflects in the approved budget, funds needed for regular expenditures. The policy established the additional reserve to address any forecast discrepancies, early asset deterioration or additional needs to fund capital replacements. The spending of these funds requires Board approval and policy specifies use of this reserve to cover costs to keep the system in a "state of good repair" only.

Jon Baldwin, Assistant Treasurer provided detail about the KCM investment pool. King County staff manages the broad array of pool investment funds. There are restrictions on withdrawals based on dollar amounts needed and the availability and maturity date of investments. Sound Transit bases the decision to use this fund on the advantage of leveraging services provided by King County and the return provided.

Ms. Priestly noted three areas of significant changes within the financial statements. The Statement of Net Position increased significantly with continued progress on the capital program and the issuance of \$943M of parity green bonds with net proceeds of \$600M after advanced refunding of the 2007A parity bonds. Current liabilities remain comparable to the prior year. The Statement of Revenues and Expenses shows the net subsidy loss decreased with the update of the cost allocation plan, growth of fare revenue, and the \$14.8M in additional capitalized cost over the prior year. Non-operating Revenues increased significantly due to higher tax revenues.

In addition to significant changes, the report includes two unique differences including large insurance recoveries on prior paid claims and preventative maintenance grants not received in prior years. Federal capital contributions decreased as U Link and S200th Extensions approach completion. As other projects progress, this number will increase. Eastlink funding is also from the federal and receives preferred interest rates based on the TIFIA loan. This may affect next year's numbers.

Fare revenue growth was strong. Link and Sounder were up 14% over the prior year. The Average Fare per Boarding (AFB) for link increased 8.6% reflecting the \$0.25 fare increase. Total operating expenses increased in relation to the update to the cost allocation plan. Administrative expenses decreased by \$18.5 million. Some of these costs shifted into the operations and maintenance category. Additional regular riders using payment methods like ORCA cards can result in AFB decreases though ridership increases.

Ms. Priestly continued with a summary of capital spending noting that amounts fluctuate by project according to the project phase. U Link project spending decreased as the project approaches completion. Spending on North Link, East Link and I-90 projects (ST Express) increased. Sound Transit now has \$7.2B in capital assets. Of this amount, 43% reflects projects currently in planning and construction and 31% reflects current buildings and transit facilities. There were no major project capitalizations in 2015.

Because Sound Transit receives federal funds, the agency is required to report specific information. The audit performed by KPMG looks at the data collection methods to inform and provide assurances at the federal level. In summary, the NTD report shows that Sound Transit is above targets for ST express and

Sounder in fare box recovery. The report also includes information about source of funds and operating recovery. Staff will present results of final reports published by the NTD to the Committee along with peer comparison statistics when available. Information about Subarea Tax Revenue Allocation is included in Boardmember packets.

## **BUSINESS ITEMS**

### Minutes from the March 17, 2015 Audit and Reporting Committee meeting minutes

**It was moved by Vice Chair Dave Enslow, seconded by Boardmember Moss, and carried by unanimous vote that the minutes of the March 17, 2015 Audit and Reporting Committee Meeting Minutes be approved as presented.**

## **FINANCIAL REPORTING**

### First Quarter Financial Report

Brian McCartan, Executive Director of Finance and IT introduced John Baldwin, Assistant Treasurer and Ted Lucas, Director of Contracts and Procurement to join him for the presentation of the first quarter financial reports. Mr. McCartan noted that first quarter trends are consistent with the reported fourth quarter financials. Revenues continue to outperform budget, operating departments are slightly below budget. A lower than forecasted fuel cost contributes to this on two of the three modes. Capital budgets are in historical range with the exception of three projects that are trending above budget for the year but not the lifetime budgets. The Northgate Link, East Link and S 200th Link Extensions are tracking at or below their lifetime budgets.

### First Quarter Asset Liability Management Report

Mr. Baldwin reported that there are no changes in stoplight indicators over the last quarter. Total restricted and unrestricted cash was \$1.2B. Average investment yield was 1%, an increase of 10 basis points from the fourth quarter. Mr. Baldwin summarized yields for the State investment pool, King County pool, and unrestricted investments. The State investment pool serves as the main liquidity tool to meet every day obligations like daily operating costs and payroll and by nature are shorter term. Open market investments (unrestricted ST investments) are longer in nature and provide a better yield than the State investment pool. The King County pool is able to invest a portion of funds in the longer term providing higher yields for that portion of funds. Interest earnings on investments were \$6M over budget due to fair market value changes. Without fair market value changes, interest earnings would be only \$200K above budget. Fair market value dropped last year when interest rates were increased. Sound Transit's strategy is to hold investments through maturity so unrealized gains and losses rarely apply to the agency's investments. The YTD return for the capital replacement portfolio is below the benchmark. Sound Transit does intentionally maintain some holdings with a maturity of less than one year to provide availability for future investment when interest rates rise. This deviates from the benchmark holdings of one to ten years. The agency increased both the operating and emergency loss reserves in the first quarter per the 2016 adopted budget. The agency is meeting all investment compliance guidelines and the long-term borrowing rate remains low with the fixed rate at 3.62% as of the end of the quarter. Recently, the Federal Reserve announced that they would maintain the current rate.

### First Quarter Contract Reports

Ted Lucas, Director of Procurement provided the report. Mr. Lucas reported that the Procurement division is responsible for the public procurement process for all agency departments for all goods and services. Resolution R78-2 established the agency's procurement policy and required that staff provide quarterly reports to the committee. The first of these reports includes competitive contracts up to \$200K awarded by the CEO. The second includes proprietary and sole-source contracts awarded. These contracts are greater than \$10K but not greater than \$100K and awarded through a rigorous process for evaluation and recommendation. This report includes two contracts awarded in the first quarter.

These reports provide the Committee with information about the delegation of authority given to staff. In addition, the Board requested a fourth report that provides a quarterly list of all open contracts greater than \$100K. These contracts could have been awarded several years prior but remain open. This is the largest report and is included to provide visibility to the Committee of all open contracts.

## **INTERNAL AUDIT UPDATE**

### 2016 Performance Audit Update

Jack Hutchinson, Internal Audit Director reminded the Committee that in March, they approved Job Order Contracting (JOC) as the 2016 performance audit topic. Following the approval, Mr. Hutchinson worked closely with the procurement and contracts group to draft and publish the Request for Proposal (RFP). The RFP closed on May 24 and proposals are under evaluation.

### Internal Audits Completed

Jack Hutchinson introduced Shelli Applegate, Sr. Internal Auditor to provide a summary of results of two audits completed since the previous meeting: Sounder Commuter Rail contract management and project labor accounting.

Ms. Applegate reported that much of the Sounder commuter rail program is outsourced. The Sounder contract management audit looked at monitoring controls to ensure that Sounder program partner billing is compliant with contract terms and conditions. The audit objective was to determine whether Sound Transit has implemented effective management controls to provide reasonable assurance of the accuracy of those Sounder contracts cost billings. The agency has five key contracts with four different contractors representing approximately 96% of the Sounder operating budget. BNSF railway operates the trains, performs train dispatching and right-of-way maintenance. Amtrak maintains Sounder vehicles at their maintenance yard in Seattle. Stacy and Witbeck maintains the Sound Transit-owned right of way in the Tacoma Lakewood area. Electromotive Diesel performs overhaul work on the locomotives. The audit concluded that management has implemented sufficient monitoring controls and they are effective with a single exception. The exception relates to the shared service facility maintenance cost in the Amtrak contract. The audit noted some billing errors and items as not eligible for reimbursement under the current contract language. Internal Audit recommended that Operations increase oversight on the shared service facility maintenance invoices, consider revising the contract language to include costs not currently, explicitly allowed, and to obtain credits for the billing errors. Management agreed and began to take steps to address these issues as noted in the management response report.

Boardmember Enslow asked about the potential Sound Transit maintenance facility in Lakewood and if this would remove the need to use the Amtrak facility. Martin Young, Sounder Operations Manager explained that the construction of a Sound Transit maintenance facility in Lakewood would require a separate contract bid and provide a contract from a competitive bid process. Amtrak with strategic location here will still play a part for some scope including as a layover for Sound Transit trains during the day and other minor work. Maintenance will primarily occur in Lakewood. Staff intends to review all invoices to ensure that additional billing errors do not exist and go unaddressed. The audit also discovered that the agency is paying the Washington State public utilities tax twice for the Sounder commuter rail service. Once directly to the Washington State DOR but also indirectly through payments made to BNSF. The agency was not aware that there is a state tax deduction for the public utilities tax. Ms. Applegate noted that the report incorrectly identifies the issue as a duplicate payment. In actuality, the agency did not make two payments. The agency made a single payment and then payed additional taxes through BNSF. Recommendation for the accounting division to obtain a credit for previous years allowable deductions, begin taking the deduction going forward and consider implementation of controls to assist in identifying other available tax deductions. Management concurred with the recommendations and the agency has received a tax refund of \$610K plus interest for the previous year's tax deduction.

Project Labor Accounting refers to the agency's processes to record, compile and report staff labor hours that are associated with the agency capital projects and operational modes. The project labor accounting audit focused on Sound Transit employee time sheets and allocation of hours to specific projects. The audit

reviewed management controls to provide reasonable assurance of the accuracy and completeness of reported and recorded project hours. Management uses this information for both internal and external reporting to both the Federal Transit Administration and National Transit Database. No noted findings. The audit found that employees accurately allocated and reported times. Mr. Hutchinson noted that this also has implications related to Grant reimbursement funds and this audit helps to mitigate those funding risks.

#### Internal Audits in Progress

Mr. Hutchinson provided a summary of audits in progress. A wireless device program audit performed in 2013 identified a process area related to management monitoring for improvement. This follow up audit examines the actions management has taken or is in the process of taking to mitigate the issue identified in the audit report. A previous audit of the indirect cost rate review on the A&E contracts architectural and engineering contracts identified exceptions. This follow up audit ensures management has effectively mitigated weaknesses in controls that led to the identified exceptions. This also ensures that those exceptions are less likely to occur in the future. To the extent that those exceptions still exist or the controls associated with the exceptions remain at an unacceptable level, Internal Audit would report these back to the Committee. The previous risk assessment audit of agency wide information technology, discussed with the Committee in March, is part of the 2016 work plan and kicked off last month. Auditors have completed one round of interviews and are defining an audit plan. An audit of the Diversity Program reporting and records management is also included in the 2016 work plan. Chair Johnson asked that staff provide a briefing about the Diversity Program.

#### **EXECUTIVE SESSION**

At 12:33 p.m., Chair Johnson announced that the Board would convene an executive session that would last 15 minutes. Loren Armstrong, General Counsel, announced that the executive session is authorized under RCW 42.30.110 subsection (a). Chair Johnson noted that the Board would not consider actions following the executive session.

At 12:48 p.m., the executive session was extended 5 minutes.  
At 12:53 p.m., the executive session was extended 3 minutes.  
Chair Johnson reconvened the meeting at 12:56 p.m.

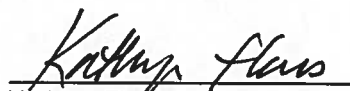
#### **NEXT MEETING**


September 15, 2016  
11:00 a.m. to 12:30 p.m.  
Ruth Fisher Boardroom

#### **ADJOURN**

The meeting adjourned at 12:56 p.m.

ATTEST:

  
Kathryn Flores  
Board Administrator

  
Rob Johnson  
Audit and Reporting Committee Chair

APPROVED on September 15, 2016, LM