
Debenture Servicing Audit

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1. Introduction

The Office of the City Auditor's 2005 Annual Work Plan included an audit of the Debenture Servicing process. The City of Edmonton utilizes two types of debentures: private issues and public issues.

Private Issues are debentures primarily issued to the Alberta Capital Financing Association (ACFA), the Receiver General for Canada, the Provincial Government of Alberta, or the Canada Mortgage and Housing Corporation. Private Issue debentures are issued or sold, under the direction of the City Treasurer, as authorized by City Council. Authority to pass debenture bylaws for capital borrowing comes from the Municipal Government Act.

Public Issues are City of Edmonton debentures which have been issued and sold to the public. As with private issues, the proceeds from the public issue debentures have been used to pay for the construction of Capital Projects, such as the Genesee Power Plant. These debentures were issued under the same authority as private issues. When Public Debentures were issued, the Treasury Section coordinated the entire process and ensured that all authorizing documents (such as certified copies of the bylaw contracts and an original debenture register) were in place. Treasury then initiated the Debenture Transfer process within the Debenture Tracking System (DTS). The City of Edmonton last issued public debentures in 1993 and those debentures mature on September 14, 2018.

All of the outstanding debentures currently listed on the Debentures Tracking System were issued for construction of the Genesee Power Plant. After Edmonton Power Department became EPCOR, they began reimbursing the City for all interest and Sinking Fund payments as they come due.

General public debentures have been issued in three different forms:

1. "Bearer" debentures are not registered and are the property of the person who "bears" them. Several different denominations have been issued, most commonly \$1,000, \$5,000, \$25,000, \$100,000, and \$1,000,000. These denominations have coupons attached, each with specific interest payment date and interest amount. The holder clips the coupons on the interest payment date and presents them at the bank for payment.
2. Debentures "Registered as to Principal only" are the same certificates as bearer debentures except that the name of the holder is typed on the back of the debenture. Thus the principal portion of the debenture is registered, but the coupons remain in

bearer form. The holder's name and address is also recorded in the Debenture Register.

3. "Fully Registered" debentures have no coupon attached. The holder's name is typed on the front of the certificate and the holders name and address is recorded in the debenture register. Interest payments are made by cheque. Fully registered debentures were issued in denominations of \$1,000 or any multiple thereof.

2. Objective

The objective of this audit was to conduct a debenture servicing review of the public issue debenture process, specifically the processes related to the transfer process, interest payments and the corporate debenture tracking system control procedures for the City of Edmonton's Public Issue debenture servicing process.

3. Scope and Methodology

For purposes of this audit the OCA focused on the Public Issue debenture servicing process and all debentures outstanding and listed within the Debenture Tracking System (DTS).

\$575 million of Public Issue debentures were outstanding on the Debenture Tracking System as of December 2005. The principal and interest paid in 2005 on these debentures totalled approximately \$90 Million. Additional payments totalling approximately \$50 million were made in 2005 on debentures (series IB) that matured during the year. The OCA completed the following steps in conducting this audit:

1. Met with relevant parties to discuss the debenture servicing process.
2. Reviewed significant policies and legislation, i.e., City Policy C203B and Municipal Government Act in relation to debt management fiscal policy.
3. Conducted a risk identification and assessment of the debenture servicing process.
4. Visited the security vault and tested the blank series certificates.
5. Verified and reviewed City of Edmonton debenture transfer procedures.
6. Verified and reviewed City of Edmonton interest payment procedures.
7. Determined compliance with applicable policies and procedures.
8. Prepared and mailed confirmation letters to debenture holders to confirm balances of debentures outstanding and account information.
9. Reviewed Debenture Tracking System for adequate application controls and environmental controls to protect against service interruption and unauthorized access.

4. Observations and Analysis

4.1. Vault Security

The OCA visited the vault to check for physical security of un-issued blank debenture certificates. The OCA observed that overall there are very good access security controls in place.

The OCA sampled bundles of un-issued blank certificates for condition and numerical sequencing. All certificates sampled were found to be in chronological sequence and no anomalies detected.

There is a large inventory of un-issued blank certificates (Fully registered) that is stored in the vault. These certificates do require signatures and denominations in order to be completed and, as an extra control, the personnel who are authorized to sign the certificates do not have single access to the vault to physically obtain the certificates.

The OCA and Administration agreed that it would be best to minimize the large amounts of un-issued certificates in inventory, especially those that have matured, and all other certificates that are unlikely to be used in the near future. Decreasing the inventory available will help mitigate potential risks of certificates being lost or stolen.

| Recommendation 1 | Management Response and Action Plan |
|--|--|
| <p>The OCA recommends that Treasury management minimize the quantity of un-issued certificates in inventory.</p> | <p>Accepted Comments: <i>Management Agrees with this recommendation.</i></p> <p>Planned Implementation: <i>Immediate</i></p> <p>Responsible Party: <i>Treasury Section, Finance Branch, Corporate Services Department</i></p> |

4.2. Debenture Transfer Procedures

The OCA observed the debenture transfer procedures to verify that they are being carried out as outlined in the procedures and that proper segregation of duties is being followed.

The OCA walked through a live transfer with staff and sampled several transfers that took place in 2004 and 2005. The OCA found that proper procedures, approval segregation and controls are in place to properly process debenture transfers.

The OCA verified the power of attorney and pertinent dates on all transfers that were received and found all to be in order. In situations where the appropriate conditions

were not met, Treasury management could not execute the debenture transfers received; therefore, rejection letters were forwarded to debenture holders explaining those reasons.

4.3. Debenture Interest Payment Procedures

The OCA verified the debenture interest payment procedures to ensure that procedures were adequate and appropriate controls are in place. In addition, the OCA observed an interest payment process that was completed at the end of 2005.

The OCA found that proper segregation of duties and operational controls are in place to ensure that interest on outstanding debentures is accurately paid.

4.4. Confirmation of Outstanding Debentures

The OCA forwarded confirmation letters to all public issue debenture holders listed on the Debenture Tracking System.

As outlined in Table 1 (Confirmation Statistics), a 100% sample of all outstanding debenture holdings was taken. The OCA then forwarded requests for confirmation of the amount, address and account to the registered Debenture owners.

Eighty-two percent of debenture holders responded to the requests for confirmation, accounting for 99% of the outstanding debenture balances (\$568,411,000).

Six adjustments were required as a result of the response (this represents 12% of all the debenture holders who responded). The adjustments consisted of five address changes and one account number change. There were no adjustments associated with the balances outstanding. All balances were confirmed as accurate by debenture holders who responded.

The Treasury Section will follow up on those adjustments received and update the database accordingly.

Table 1 – Confirmation Statistics

| Description | Sent Out | Response | No Response |
|--|---------------|---------------|-------------|
| Total Value of Outstanding Debentures | \$573,900,000 | \$568,411,000 | \$5,489,000 |
| Number of Confirmations | 60 | 49 | 11 |
| Responses (%) | 100% | 82% | 18% |
| Percentage of \$ Balance Confirmations | 100% | 99% | 1% |
| Adjustments (% of total responses) | n/a | 12% | -- |
| Number of Adjustments | n/a | 6 | -- |

| Recommendation 2 | Management Response and Action Plan |
|--|--|
| <p>The OCA recommends that the Treasury Section take the appropriate action to update the Debenture Tracking System (DTS) database with the changes received from the debenture holders.</p> | <p>Accepted Comments: <i>The Treasury Section will update the DTS with address changes. With respect to the Account number change, they will contact the debenture holder, request debenture certificate and backup documentation and complete the exchange accordingly.</i></p> <p>Planned Implementation: <i>Immediate</i></p> <p>Responsible Party: <i>Treasury Section, Finance Branch, Corporate Services Department</i></p> |

4.5. Debenture Tracking System Controls

The Debenture Tracking System (DTS) is used to administer public debenture debt. The DTS has a database of debenture issues, debenture holders and agents as well as issued and outstanding certificates. The DTS is used to produce interest and principal payment files for Accounts Payable, maintenance of debenture transfers and exchanges and T-5 production – Canada Customs and Revenue Agency Form. In addition, it incorporates extensive query and reporting capability. There are security features built into the system to ensure separation of duties and ensure that all processes are secure, requiring the involvement of two or more staff members.

Information Technology and SAP business resources provided the DTS database to the OCA for analysis on January 25, 2006.

The OCA conducted a number of tests:

1. Checked security features built into the system programming to separate approval duties. This is required for debenture transfer procedures and interest payment procedures.
2. Ensured that all processes require two or more staff member logons.
3. Verified that access to DTS has an extra layer of security, requiring that the database has to be loaded onto an individual's desktop computer to gain access.
4. Queried some reports to review a sample of transfers processed over the years.

The OCA observed that different logons were required for all processes and no one logon could perform a complete task. Individuals were only able to perform partial tasks. In addition, only six registrants can access the software.

5. Conclusions and Recommendations

The OCA conducted an audit of the Public Issues debenture process. This audit included a risk identification and assessment, verification of debenture transfer and interest payment procedures, a physical security check of the vault, testing un-issued certificates and a 100% external confirmation of outstanding public issue debentures.

The OCA has concluded that the process for servicing the City's public issue debentures has adequate controls in place. Management has accepted the recommendations included in this report and supplied acceptable action plans.

The OCA thanks the Treasury Section staff for their time and assistance during this audit.