

February 6, 2013

Metrolink Board of Directors
One Gateway Plaza, 12th Floor
Los Angeles, California 90012

Subject: **Metrolink Finances (Item #7)**

Dear Metrolink Board of Directors:

Attached are the Ad Hoc Finance Committee's findings and recommendations related to Metrolink's finances and board agenda item #7 on February 8, 2013.

The findings do not reflect an agency that is where it needs to be with its finances however all of the findings are fixable. The committee is optimistic and confident that the new chief executive officer understands the seriousness of the situation and is committed to address the underlying issues in a substantive and timely manner. The board should share this optimism and confidence in the CEO.

To address the findings, the CEO will need both time and resources, and he should advise the board on his needs in both areas so that we can implement the necessary reforms successfully. The board also is recruiting a chief auditor and that new person will be integral to bringing more transparency to the board and bolstering the efforts of the CEO.

We want to commend Chair Morris, former Chair Katz, and the entire board of directors for asking us to undertake this important work. Metrolink provides vital transportation services in Southern California and a strong financial foundation is important to our agency. All the findings can be resolved and we look forward to seeing Metrolink on stronger financial footings in the near future.

Sincerely,

Carolyn Cavecche
Ad Hoc Finance Committee

Jaime de la Vega
Ad Hoc Finance Committee

c: Michael DePallo, CEO

Attachment

Metrolink Board Report

Date: February 6, 2013
To: Metrolink Board of Directors
From: Ad Hoc Finance Committee
Carolyn Cavecche
Jaime de la Vega
Copy: Michael DePallo, CEO
Subject: **Metrolink Finances**

ITEM 7

SUMMARY

This memorandum summarizes the findings the Ad Hoc Finance Committee (“committee”) and makes recommendations for the Metrolink Board of Directors (“board”).

RECOMMENDATION

The committee recommends that the Metrolink Board of Directors direct the CEO to address the findings in this report and:

1. Report back to board within 30 days with clear, concise financial statements reflecting Metrolink’s past (prior 2 fiscal years), current (fiscal year 2013), and projected financial condition
2. Report back to the board within 30 days with a response to the findings and a work plan for board approval to address the issues
3. Report back to the Ad Hoc Finance Committee monthly with a progress report on work plan implementation

INTRODUCTION

This memorandum is limited to policy and oversight issues as they relate to the Board of Directors. This document does not delve deeply into the technical aspects of the issues or underlying causation, which are subjects that should be and are the responsibility of the CEO to address.

This memo does contain options for consideration by the CEO and board. The committee provides these as ideas for consideration, but they are not an exhaustive set of strategies. The CEO should be responsible for identifying options and recommending a preferred strategy that address the findings to the board.

FINDINGS

Finding 1 – Metrolink finances are not clearly presented to the Board of Directors

A fundamental finding of the committee is that the data and information presented to the board is inadequate in both presentation and content. Typical revenue and expense statements as well as schedules showing cash flows are not available.

Prior Metrolink management and current staff have identified the lack of a robust financial information system as a key deficiency. The committee concurs, however this does not explain why accurate financial schedules cannot be produced from the available data, even if this is a labor intensive process.

As a result, the board is unable to make informed decisions or to accurately understand Metrolink's financial positions on both a cash and accrual basis. To the extent that certain financial information has been communicated to the board previously, this has been wholly inadequate.

Finding 2 – Metrolink staff unable to provide supporting schedules

Finding 1 may be the result of an inability to summarize available data in a format that informs the board and enables it to make high level policy and budget decisions. However, when the committee requested detailed schedules that contained the underlying data used in the financial summaries, Metrolink staff did not produce the requested documentation. It is unclear why this could not be accomplished.

Finding 3 – Inadequate cash reserves

Metrolink has inadequate cash on hand to meet existing and near-term obligations. Also, funds provided to Metrolink for restricted purposes that should be available in cash are not available. On a cash basis, these funds are significantly under-funded. Obviously Metrolink's cash position changes daily as revenue is received and expenses are paid. However, an illustration of the problem will illuminate the finding.

On December 14, 2012, Metrolink staff presented summary data with the committee. The data showed that Metrolink only had \$60 million cash on hand, yet it should have had at least \$88 million in cash deposited for various restricted purposes. In addition, Metrolink had \$38 million in near-term accounts payable and payroll expenses. This put Metrolink's financial position at \$22 million on an accrual basis (\$60 million - \$38 million = \$22 million). This implies that Metrolink restricted funds are underfunded by \$66 million.

In addition, Metrolink staff identified other upcoming cash needs of \$78 million for operating expenses (one month), capital/third party expenses (three months of front funding), and contingency.

Metrolink staff stated that cash flow problems started or were exacerbated by member agency actions (see finding 5 below). However based on information provided by Metrolink staff, it is unclear exactly when Metrolink began experiencing cash flow problems. No documentation was provided to the committee demonstrating the issue.

Finding 4 – Inadequate accounting & segregation of funds

Based on the available information and statements by Metrolink staff, it appears restricted funds have been, at best, borrowed to meet cash flow needs and, at worst, co-mingled. Both actions are inappropriate and have not been disclosed previously to the board.

It is unclear if documentation exists that describes actual cash flows. The committee does not know if separate accounts or funds are maintained or if financial schedules are maintained that properly segregate the funds on an accounting basis.

Assuming that Metrolink staff, in fact, only borrowed money from restricted funds to meet cash flow needs, then documentation should exist showing the temporary outflow of funds from the restricted fund as well as the subsequent replenishment of funds at a later date. No such documentation has been provided to the committee.

Finding 5 – Change in member agency procedures

Metrolink staff indicates that the five member agencies changed their procedures in front funding capital projects. The change appears unilateral by the member agencies and was not approved or ratified by the Metrolink board. If Metrolink management or staff concurred, the committee is unaware of any documentation agreeing to the change.

It is the committee's understanding that the change was initiated by member agencies in 2010 because Metrolink had large unspent balances of prior capital funds and that member agencies did not want to appropriate or transfer funds to Metrolink if they were not going to be spent within a certain timeframe.

The impact of not front funding capital projects is that Metrolink currently fronts construction costs and then waits for reimbursement from the member agencies. Metrolink staff has used cash balances in what should be restricted accounts or funds to meet capital cash flow needs.

This finding is not a critique of either the current or prior practices. Both are valid policy approaches.

It is unclear from the information available if then procedural change had any substantive impact on Metrolink's cash flow problem (finding 3). Specifically, no documentation was presented by Metrolink staff showing that the agency's cash position prior to the procedural change was sufficient to meet cash needs (accounts payable).

Finding 6 – Delay in member agency payments (undocumented)

Metrolink staff communicated that member agency payments have been delayed due to lack of ratified memoranda of understanding (MOU). Specifically, Metrolink does not receive funds at the beginning of each quarter, creating or exacerbating cash flow issues.

Finding 7 – Inaccurate record keeping

This finding is related to finding 1, but is identified separately to bring transparency to the issue. Based on the documentation provided, it is not clear that Metrolink staff even has a clear idea about what funds member agencies owe. This appears to be a partial underlying cause of finding 1 and the committee is concerned that this is a microcosm of Metrolink staff's record keeping across the board.

Finding 8 – Lack of confidence in financial information and systems

Based on information provided to date, the committee does not have confidence in Metrolink's financial information and systems. It is unclear how the quality of information available supports informed, strategic decision making by the CEO and board.

Metrolink staff has acknowledged many, if not all, of the deficiencies identified by the committee. Notwithstanding the findings, the committee is convinced that Metrolink staff understands that there are significant issues that need to be resolved, even if staff currently cannot articulate the depths and details of the problems.

Unfortunately, this understanding by Metrolink staff does not alleviate the committee's strong reservations about Metrolink's finances. Much needs to be done and Metrolink's finances need serious and immediate attention.

Metrolink staff's desire to see timely payment of some and prepayment of other expenses by member agencies is understandable. But the committee firmly believes that any discussion about how to resolve Metrolink's financial morass must be preceded by a clear, concise, and comprehensive understanding of revenues, expenses, and cash flows.

Metrolink staff must be able create confidence in the board and the member agencies that funds are not only being used for purposes consistent with the agency's mission, but that they are being accounted for and used for the specific purposes intended. While the board has rightly pushed forward with important safety investments, it has done so without a complete understanding of how these decisions impact Metrolink and member agencies current and future budgets.

Conclusion

Without addressing the findings and recommendations in this report, the committee cannot recommend that member agencies commit additional funds at this time. Obviously, quarterly transfers to pay for daily operations must continue if Metrolink service is to continue, albeit with the caveat that final transfer amounts are reconciled in the near future.

OPTIONS

The following identifies some options and internal policies for addressing the committee's findings. The list is not exhaustive and the strategies may not be mutually exclusive.

Separate accounts by purpose

Metrolink should consider establishing separate accounts for all restricted funds. This should be done immediately and should not wait for implementation of an upgraded financial system.

If the financial system allows, Metrolink should establish sub-accounts for specific projects or programs. For example, Metrolink could maintain a single capital account with separate sub-accounts for individual projects.

Separate accounts by county

Metrolink could establish five separate accounts for each member agency. (This could be combined with separate accounts by purpose within in each county account.) Funds approved for transfer by the respective member agency board of directors and/or CEO would be segregated for accounting purposes.

Increase account control

If separate county accounts are established, control to transfer funds to Metrolink-controlled accounts or to make vendor payments could require approval of each member agency's chief financial officer (CFO). This would add a level of check-and-balance to ensure that restricted funds are not used for inappropriate purposes. It also enables individual member agencies to approve short-term inter-account transfers of unrestricted funds to address Metrolink cash flow issues.

Establish working capital

Member agencies should consider a one-time front funding of working capital, with the amount to be determined by the CEO and agreed to by each member agency's board of directors. Since the funding amount is likely to exceed \$100-150 million, Metrolink and the member agencies should consider debt instruments (possibly commercial paper) to provide the working capital. This would result in financing costs but would reduce the cash flow burden on member agencies.

Working capital also would fund the railroad parts inventory essential to Metrolink operations.

Establish an operating reserve

In addition to securing working capital for near-term expenses (1-3 month expenditure horizon), Metrolink should consider establishing an additional operating reserve. This

would address unexpected cash flow issues and enable Metrolink continuity of operations without emergency action by member agencies or curtailment of services.

Outsource financial management

Metrolink should consider asking a member agency to provide financial management services for its operation. This generally would entail using the same financial system but with segregated accounts and separate controls. This would leverage existing investment in a functioning financial system implemented by a member agency.

Transfer capital projects to member agencies

Metrolink and the member agencies should consider transferring financial and project management of non-systemwide capital projects to the member agencies of the county where the project is being built. Metrolink's core competency is not capital project development, management, and construction. This would shift front funding requirements to each member agency. This also would clarify Metrolink's primary mission as an operator. Metrolink would continue to be responsible for systemwide capital projects such as positive train control (PTC) and vehicle procurement.

An implication of implementing this option is that member agencies and their contractors would require access to the right-of-way currently controlled by Metrolink.

Pre-pay capital funding

If Metrolink retains responsibility to deliver capital projects, then member agencies should consider front funding (pre-paying) projected expenses three months in advance. Quarterly payments would balance cash flow needs with the desire to minimize administrative work. If member agencies front fund projects then they also should receive any interest income generated by unspent funds.

WORK PLAN AND DELIVERABLES

The following identifies specific actions the committee recommends in response to the findings. The CEO's work plan should include these elements or the CEO should propose a viable alternative to address the underlying issue.

1. Develop and utilize a standard reporting format for all financial reports (Finding 1)
2. Consult member agencies for account receivable balances and reconcile with Metrolink records (Finding 2)

3. Develop a cash reserve policy for Board approval (Finding 3)
4. Provide a reconciliation report on the operating, capital, and reserve deficiencies to the board within 60 days (Findings 3 & 4)
5. Develop standard policies and procedures for the accounts receivable function within 90 days to ensure timely payments from member agencies, standardized invoices and proper backup (Finding 4)
6. Establish an accounting structure that creates individual operating and capital accounts by member agency and project, respectively. This should be done immediately to allow for transparent accounting and expenditure of funds moving forward and provide a basis for the reconciliation of all past activities (Finding 5)
7. Provide a report to the board with an assessment of the financial systems currently in place (Finding 8)
 - A. Identify deficiencies
 - B. Develop a corrective action plan
 - 1) Immediate (not dependent on new financial information system)
 - 2) Long-term (financial information system)
8. Develop policies for funding both operations and capital projects (e.g. a quarterly advance pay on operations and a 40 percent advance pay on any capital projects and present to the Board for approval)
9. Develop a standard MOU for the payment of operating funds to be executed commensurate with each agency's annual budget adoption
10. Continue to convene and work with member agencies to resolve financial issues

BACKGROUND

The Ad Hoc Finance Committee was formed on January 27, 2012 to take a more in-depth look at Metrolink's finances. The committee has met six times since its formation, most recently on January 10, 2013. In September 2012, Metrolink also hired a new CEO.