



January 16, 2009

Mr. Rob Cook, Executive Officer
Department of General Services
Office of Public School Construction
1130 K Street, Suite 400
Sacramento, CA 95814

Dear Mr. Cook:

Interagency Agreement Closeout—Office of Public School Construction Training and Interim Project-Monitoring Program

The Department of Finance, Office of State Audits and Evaluations (Finance), has completed the professional services agreed to under an interagency agreement with the Office of Public School Construction (OPSC). The objective of the agreement was to provide audit specific training to the OPSC staff and to assist the OPSC in developing an interim project-monitoring program.

The enclosed report is for your information and use. This report is being reissued to correct an inadvertent error included in the original report dated December 17, 2008. In accordance with Finance's policy of increased transparency, this report will be placed on our website

We appreciate the assistance and cooperation of your staff. If you have any questions regarding this report, please contact Mary Kelly, Manager at (916) 322-2985.

Sincerely,

David Botelho, CPA
Chief Office of State Audits and Evaluations

cc: Ms. Lisa J. Silverman, Operations Manager, Fiscal Services, Department of General Services, Office of Public School Construction

INTERAGENCY AGREEMENT CLOSEOUT

Office of Public School Construction

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Final reports are available on our website at <http://www.dof.ca.gov>

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TABLE OF CONTENTS

Executive Summary..... iv

Background, Scope, and Methodology..... 1

Results..... 3

Appendix A 7

EXECUTIVE SUMMARY

The Department of Finance, Office of State Audits and Evaluations (Finance), performed professional services under an interagency agreement with the Office of Public School Construction (OPSC). The agreement required that Finance provide audit specific training to the OPSC staff. The second objective of the agreement was to assist the OPSC in developing an interim project-monitoring program.

We have met the scope of the agreement by providing training and assistance in developing a project-monitoring program. We provided OPSC with a field project-monitoring program to supplement its current desk review procedures. We met with OPSC management on November 4, 2008 to present and discuss the written procedures for interim project monitoring, including audit programs, and internal control questionnaires and matrices.

We acknowledge the efforts of OPSC's management to comply with Governor's Executive Order S-02-07 to ensure bond funds are spent efficiently, effectively, and in the best interests of the people of the State of California. By obtaining the professional services of Finance to develop an interim project-monitoring program and to provide audit specific training, OPSC aims to address weaknesses it recognized in its fiscal and managerial controls over bond funds.

In performing the services requested, we noted conditions that erode the OPSC's efforts to employ adequate fiscal and managerial controls over the School Facilities Programs (SFP). We recognize that as staff to the State Allocation Board, the OPSC does not possess the unilateral ability to implement controls and/or may not have the ability to correct the noted impediments to the development, implementation, and determination of effectiveness of fiscal and managerial controls over the SFP. However, it is critical for OPSC to acknowledge these impediments, make suggestions for improvements and to enact compensating controls. Further, we recommend that the OPSC review the fiscal controls currently employed by the other administrators of Proposition 1D-bond funds to identify measures to enhance fiscal accountability and governmental transparency.

BACKGROUND, SCOPE, AND METHODOLOGY

Background

The State Allocation Board (SAB) is a 10-member state government board that allocates general obligation bonds for the construction, modernization, and maintenance and repair of K-12 public school facilities. At its monthly meetings, the SAB also adopts policy and regulation and hears appeals on SAB and OPSC actions. The SAB board members include:

- Three Members of the Senate
- Three Members of the Assembly
- Director of the Department of Finance
- Director of the Department of General Services
- Superintendent of Public Instruction
- One Governor appointee

The OPSC is the administrative staff of the SAB and exists as an office within the Department of General Services. As staff to the SAB, the OPSC administers the School Facility Programs (SFP), which provide State funding assistance for new construction and modernization projects. The OPSC proposes changes to the regulations, policies, and procedures that carry out the mandates of the SAB and advises the SAB on policy issues and legislative implementation.

In the 1980's, the Implementation Committee (Committee) was created to advise and assist the OPSC in policy implementation by providing practitioner and stakeholder input. The committee is composed of representatives of school districts, county offices of education, contractors, labor unions, lobbyists, and other stakeholders.

In January 2007, the Governor issued Executive Order S-02-07 to ensure that state government is accountable for the expenditures of Strategic Growth Plan bond proceeds. The order requires all agencies, departments, boards, offices, commissions, and other entities of state government responsible for expending bond proceeds to be accountable for ensuring funds are spent efficiently, effectively, and in the best interests of the people of the State of California.

Scope

The scope of the interagency agreement was to assist the OPSC in developing an interim project-monitoring program and to provide audit specific training to the OPSC auditors.

Methodology

To meet the objectives of the interagency agreement, we gained an understanding of the SFP and its requirements. We reviewed Education Code Section 17070, the Leroy F. Greene School Facilities Act of 1998. We also performed a review of policies and procedures developed by the OPSC, as well as the Governor's Strategic Growth Plan Bond Accountability website.

Once we had obtained an understanding of the program, we conducted interviews and facilitated brainstorming sessions with OPSC staff. These meetings assisted us in understanding the current project review process, including OPSC's newly implemented risk assessment process.

To gain an understanding of the environment in which OPSC operates, we attended SAB and Committee meetings and reviewed prior month's minutes. Our research included reviewing documents and reports prepared by the California Research Bureau, Legislative Analyst's Office, and the Little Hoover Commission. We interviewed external entities such as a county office of education, a school district's facilities planning department, the Division of State Architect, and the Fiscal Crisis and Management Assistance Team.

Finally, to assess the adequacy of OPSC's control activities, we gained an understanding of processes in place at other state entities mandated with allocating funding for school construction programs, namely: the California Community Colleges, the University of California, and the California State University.

Training

During the period June 2008 through October 2008, OSAE provided the following training classes to OPSC staff:

- How to Conduct a Grant Audit.
- Research and Resources Presentation.
- Professionalism and Conducting Entrance and Exit Conferences.
- Yellow Book 2007 Update.
- Introduction to State Fund Accounting.

OSAE provided training to OPSC's entire professional staff, including auditors and management.

Project Monitoring Program

We determined that OPSC's current practice of performing desk reviews of projects at close out did not provide sufficient oversight to ensure that bond funds are spent efficiently, effectively, and in the best interests of the people of the State of California. In collaboration with OPSC, we developed a project-monitoring program to enhance OPSC's fiscal and managerial controls by proposing:

- District level internal control assessments.
- Management representation letters.
- Increased financial analysis of grant recipient's financial condition, including the validity of claimed encumbrances.
- Validation of the existing number of district classrooms.
- Onsite project inspections.
- Assurance that claimed expenditures are accurate and adequately supported by invoices, accounting records, and other supporting documentation.

Other Issues

As previously noted, our methodology included reviewing the Governor's Strategic Growth Plan Bond Accountability website. The OPSC complied with the requirements to submit a three-part accountability plan, detailing its activities to ensure accountability and transparency at the front end, in-progress, and follow-up phases of projects. However, in performing the services included in the interagency agreement, we noted conditions that could hamper OPSC's ability to execute the accountability plan and could impede OPSC's ability to ensure the effectiveness of the fiscal and managerial controls.

Assignment of Responsibility and Authority

The SFP's assignment of authority and responsibility to the local level may be a barrier to ensuring that proper accountability and transparency exists. As a component of the front-end phase of its accountability plan, the OPSC includes the use of the May 2008 *School Facilities Handbook*. In Section 12, Program Accountability, the handbook states: "The School Facility Program (SFP) has significantly increased program flexibility and responsibility at the local level, while reducing the state's oversight role."

This assignment of fiscal accountability to the local level is evident in the grant disbursement process. Because funds are disbursed in an advance lump sum payment, the OPSC does not have an opportunity to base funding disbursement on school district performance or project progression. Such limits on the state's oversight role could erode OPSC's ability to ensure bond proceeds are spent efficiently, effectively, and in the best interests of the people of California.

We compared the fiscal and managerial controls of the four Proposition 1D bond-funded school construction programs: the OPSC (K-12), the California Community Colleges, the University of California, and the California State University. Although the K-12 program was allocated over 70 percent of the Proposition 1D bond funds, OPSC's program contains significantly fewer fiscal controls than the three other state school construction programs.

The areas in which OPSC's fiscal and managerial controls are weaker than the comparative programs include:

- The OPSC does not require independent assessment of construction costs.
- Grantees do not submit capital budgets to the OPSC.
- No grant agreements are required between the OPSC and grantees.
- Grant disbursements are not based on actual completion of construction phase.
- No grant funds are withheld until successful completion of construction projects.

A summary and description of the fiscal controls for each program is included in Appendix A, Summary of Fiscal Controls by State Educational Program.

Override of Controls

A significant potential impediment to effectual controls is the ability of the SAB to override and negate fiscal and managerial controls established by the OPSC. In our review of SAB minutes, our attendance at SAB and Implementation Committee (Committee) meetings, and in interviews with staff, we noted several instances where overrides have occurred. For instance, as part of the provisions of Assembly Bill 127, Chapter 35, Statutes of 2006 (Perata/Nuñez), the OPSC contracted with consulting firm Macias, Gini & O'Connell to conduct an independent analysis of the cost to construct schools and to determine grant adequacy. The New School Construction Grant Adequacy Study (Macias report) concluded the state was over-funding its portion of the school construction projects. At its September 24, 2008 meeting, SAB voted to reject the findings of the Macias Report. The minutes state that the SAB "expressly declares that the report does not have the SAB's approval for citation in any administrative, fiscal or other official purpose." Additionally, a board member requested that the report be removed from OPSC's Resource website. This type of activity is contrary to the Governor's directives to enhance the transparency in state government activities.

The override of controls was also exemplified in the case of San Bernardino City Unified School District's (District) appeal to the SAB regarding OPSC findings of the District's financial hardship status. The financial hardship program provides up to 100 percent state funding to applicants who cannot meet the local match requirement. In its application for financial hardship, the District reported it had no available funds to contribute to its school construction projects. The District received 100 percent state funding for the construction of 16 schools. Upon subsequent review, the OPSC determined that the District had overstated its encumbrances and that \$24 million in District funds could be applied as match.

The District disputed OPSC's findings and appealed to the SAB. While acknowledging that the District had received excess funds, the SAB asserted that the financial hardship regulations lacked specific limitations for claiming encumbrances. The SAB overturned the findings of the OPSC and released the District from any responsibility to contribute to its construction projects.

Lack of Objectivity

The final potential impediment we observed is the organizational structure in which the OPSC functions. An essential tenet in the development, implementation and determination of effectiveness of fiscal and managerial controls is the responsibility of administrators to remain objective. However, studies by the Milton Marks "Little Hoover" Commission (Commission) on California State Government Organization and Economy report that the SAB may not have the requisite objectivity. In an August 2007 report, The State Allocation Board: Improving Transparency and Structure, the Commission found that:

1. The SAB has no formal rules of operation, leading to an unclear governance structure.
2. The majority of SAB members are elected officials, resulting in an inherent conflict of interest between the executive and legislative branches.
3. The SAB is subject to inappropriate influence that, "on occasion, has permitted politics to trump policy in allocation decisions."

We also noted that the Superintendent of Public Instruction's delegate on the board is the director of the Department of Education's School Facilities Planning Division. Because a school district must have the approval of this division prior to applying for funding from the SAB, this dual role poses a potential conflict of interest. Because the division the delegate directs provides approvals for the educational facilities that would ultimately require her approval as a SAB board member, the delegate may not possess the requisite objectivity in the consideration of projects funded by the SAB. We also noted that while the Department of General Service's Division of State Architect (DSA) is also responsible for approving educational facilities, the DSA is not represented on the SAB.

The lack of objectivity and its impact on OPSC's ability to ensure the existence of accountability and transparency is demonstrated in the composition and use of the (Committee). The committee is composed of representatives of school districts, county offices of education, contractors, labor unions, lobbyists, and other stakeholders.

Currently, the SAB refers all policy and regulation changes to the Committee for consensus. For instance, both the SAB and the OPSC have identified deficiencies in the regulations over the financial hardship program. In 2005, the Committee was tasked with identifying improvements to correct the deficiencies in the regulations. Despite the lack of resolution from the 2005 directive, again in May 2008 the SAB requested that the Committee recommend

improvements to the Financial Hardship regulations. The OPSC proposed recommended program improvements to the Committee but after eight committee meetings, there has been no progress.

As its technical staff, the OPSC is responsible for proposing policy recommendations to the SAB. However, as evidenced in the circumstances surrounding modifications to the regulations guiding financial hardship, the lack of progress has impeded OPSC's efforts to improve the SFP's administration. As noted in the August 2007 Commission report, the then chair of the SAB stated that since its inception, lobbyists and other advocates for special interests have been added to the Committee and since then, it assumed a more activist role, influencing program and policy development. As noted in the report, "the chair suggested that this has upset the balance between policy and regulation development and fiscal responsibility."

APPENDIX A

Proposition 1D, the *Kindergarten-University Public Education Facilities Bond Act of 2006*, was approved to fund \$10.416 billion in school facilities construction projects for four major state programs. Below is a comparison of the fiscal controls of each of these construction programs.

Proposition 1D Bond Accountability Summary of Fiscal Controls

| Fiscal Controls | Office of Public School Construction, K-12 (\$7.329 Billion) | California Community Colleges (\$1.507 Billion) | University of California (\$890 Million) | California State University (\$690 Million) |
|--|--|---|--|---|
| 1. Independent Assessment of Construction Project Costs | No | Yes | Yes | Yes |
| 2. Capital Project Budgets Submitted for Review | No Budget Submitted | Yes | Yes | Yes |
| 3. State and Local Project Cost Sharing Agreements | Yes | Yes | No | No |
| 4. Grant Agreements or Construction Contracts Signed Between State Programs and Local Project Management | No | Yes | Yes | Yes |
| 5. Project Payments Based Upon Progress Reports and Actual Expenditures Incurred | No | In Progress | Yes | Yes |
| 6. Program Authority to Approve Change Orders | No | Yes | Yes | Yes |
| 7. Project Expenditures Reviewed to Analyze Variances | No | Yes | Yes | Yes |
| 8. Percent of Actual Expenditures Withheld Until Successful Completion of Projects | None | Yes | Yes | Yes |
| 9. Final Construction Project Costs Independently Audited | No | Yes | In Progress | Yes |

The following describes the fiscal controls in each Proposition 1D bond-funded school facilities construction program:

Office of Public School Construction

The Office of Public School Construction (OPSC) does not require an independent assessment of construction costs on capital projects; nor does it require a capital project budget. The School Facilities Program requires both state and local matching funds for new construction (50/50) and modernization (60/40) projects, unless it is a financial hardship project. There are no grant agreements between the OPSC and grantees. Grant funds are disbursed in an up-front payment for the entire grant amount.

California Community Colleges

The 72 community college districts apply directly to the California Community College (CCC) for Proposition 1D funding. The CCC assesses proposed construction costs using its Building Cost Guidelines before projects are started. Construction project budgets are submitted to the Department of Finance (Finance) in the capital outlay budget process. The CCC does not require local funding of projects, but preference is given to projects using local funding sources. Project payments are made through the reimbursement of actual expenditures incurred. The CCC approves project change orders requiring additional state funding. Final payments are withheld until all project expenditures have been reported. Projects that are jointly funded by state and local sources are independently audited after completion.

University of California

The University of California (UC) receives independent assessments of construction costs through external architectural/engineering firms before projects are initiated. Individual campuses develop a Project Planning Guide that includes the scope, schedule, and budget for each of their projects. Final construction project budgets are submitted to Finance in the capital outlay budget process. Funding is transferred to campuses to cover project expenses for each phase. Campuses report all expenditures to the State Controller's Office. Construction progress reports and actual expenditures incurred are monitored and change orders are approved at the campus level. The final payment is withheld from the contractor until a Notice of Completion has been issued. The UC is currently working on a process to have its facilities construction projects audited after completion.

California State University

The California State University (CSU) independently verifies construction costs through independent architectural/engineering firms. In addition, the CSU budgets for future project costs using a baseline cost guide and the Department of General Services' Construction Cost Index. Facility construction budgets are submitted to Finance in the capital outlay budget process. Each month, the CSU disburses project payments based upon a schedule of actual work completed and expenditures are monitored against budgeted line items. The CSU withholds at least five percent of project expenditures incurred until the Notice of Completion has been issued. The CSU contracts for independent audits of the completed construction projects.