REPORT OF THE EXECUTIVE OFFICER
State Allocation Board Meeting, May 27, 2009

# DEPARTMENT OF FINANCE, OFFICE OF STATE AUDITS AND EVALUATIONS REPORT

## PURPOSE OF REPORT

To discuss the interagency agreement close-out report prepared by the Department of Finance, Office of State Audits and Evaluations (Finance).

## DESCRIPTION

In September 2007, an independent performance audit of the Financial Hardship program was presented to the State Allocation Board (SAB). The SAB accepted the report and requested Staff to develop and present a work plan to implement the audit recommendations. That work plan was presented and approved at the October 2007, SAB meeting.

In order to implement the recommendations proposed in the work plan, the Office of Public School Construction entered into an interagency agreement with the Department of Finance. On January 16, 2009, Finance issued the Interagency Agreement Close-out report, included as Attachment A. This report details the Department of Finance's methodology and results. Also included are:

- Evaluation of the California Office of Public School Construction Financial Hardship Review Program, September 18, 2007, as Attachment B
- Work Plan for improving the Financial Hardship Program, October 23, 2007, as Attachment C
- Interagency Agreement (No. 3122654) "Scope of Work", as Attachment D

This item was presented at the February 25, 2009 SAB meeting. At the March 11, 2009 SAB meeting, a Board member requested that the report be brought back to the March 25, 2009 SAB meeting for further discussion. At the March 25, 2009 SAB meeting this item was postponed and requested to be brought back to the April 22, 2009 SAB meeting.

ATTACHMENT A

# Interagency Agreement Closeout

# Office of Public School Construction

Prepared By:
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# 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.

ATTACHMENT B

MACIAS
CONSULTING GROUP

# Evaluation of the California Office of Public School Construction Financial Hardship Review Program

## California Department of General Services
## Office of Public School Construction

September 18, 2007

## Final Report

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## MCG Executive Summary
## Evaluation of the OPSC Financial Hardship Review Program

September 2007

### Why Macias Consulting Group Conducted this Review

Since 1998, the California Office of Public School Construction (OPSC) has provided about $3 billion in grants to school districts and county Offices of Education (herein referred to as school districts) to help build and/or modernize K-12 educational facilities. To help allocate the grants available, the California legislature established the Financial Hardship Program under the under the Leroy F. Greene School Facilities Act of 1998 that is designed to identify and certify school districts that are experiencing "financial hardship". School districts receiving "financial hardship" designations become eligible to receive up to 100 percent of State funding to cover the cost of each construction project submitted for State funding appropriation within a six-month period. School districts must reapply for the financial hardship certifications every six months. To be certified as "financial hardship", the school district must demonstrate that it has an unmet need for pupil housing due to extreme financial, disaster related, or other hardship, or is not financially capable of providing the contributing shares otherwise required for state funding participation. The school district must also demonstrate that it has made all reasonable efforts to impose all levels of local debt capacity and development fees unless the applicant is a county office of education. In exception cases, the school district must demonstrate that due to unusual circumstances that are beyond the control of the district, excessive costs will be incurred in the construction of school facilities

The Financial Hardship Program (Program) has been the subject to public debate and OPSC sought an independent firm to (1) assess the adequacy of the current Financial Hardship Program, (2) evaluate internal controls, and (3) provide recommendations on areas that can be improved.

To accomplish these objectives, Macias Consulting Group evaluated the Program by reviewing governing regulations, application instructions and forms, and discussed the funding approval process with OPSC staff. Also, our firm examined a sample (15) of Financial Hardship Program applications that were submitted by school districts and represented 87 percent of $233 million in funding allocated to school districts in FY 06-07. Finally, we analyzed performance metrics to further assess the strengths and weaknesses of the Financial Hardship Process.



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## What Macias Consulting Group Found

From FY 1997 - 2007, OPSC distributed nearly $3 billion among 271 school districts, county offices of education, and schools for construction and modernization of K-12 facilities. While the Financial Hardship Program has supported education throughout California, our study has identified several noteworthy accomplishments by OPSC.

The results of our evaluation showed that OPSC has been instrumental in reallocating millions of dollars to additional school districts applying for funding by requiring applicants to contribute more of their own funding to facility construction projects. Our analysis of a representative sample of applications indicated that OPSC identified that of 33,717,528.50 in funding requested from applicants, OPSC identified that nearly $27 million could be contributed to other construction projects and was the responsibility of applicants for facility construction projects, which prevented the State from assuming the total costs. OPSC has also been proactive in efforts to strengthen the Program by revamping application instructions and instilling uniformity in its internal submission review process. Moreover, OPSC's quick responsiveness to assigning staff to review Program applications upon submittal is commendable.

Nevertheless, the results of our review showed some key areas of concern:

1. Lack of equity and fairness in the distribution of State facility construction funds,

2. Indebtedness requirements that cause applicants to unnecessarily take on more debt to qualify for State construction funding,

3. Inability to determine the accuracy of financial data submitted by applicants,

4. Outdated review process administered by OPSC reviewers.

First, the Financial Hardship Review Process needs a regulatory framework that ensures a fairer and more equitable allocation of available State facility construction funding. The current regulatory framework and the subsequent Financial Hardship Review process developed by OPSC has created a condition that is more beneficial to larger school districts than smaller ones. Our analysis showed that many larger (e.g. medium and large) urban school districts were not required to contribute any of their own available funds to facility construction. In contrast, most of the smaller school districts in our review were required to use 13 to 70 percent of their available funds. As an example, a larger and urban school district had $28.5 million available for construction projects, but the Financial Hardship Program determined that they had zero available funding to contribute to the project, and as a result the school district will not have to contribute any local funds to its facility construction project(s). However, one smaller and rural school district in Northern California had a total of $233,000 available for construction projects and the Financial Hardship Program required the school district to contribute up to 70 percent of those funds to facility construction.

The equity and fairness issues in the Financial Hardship Review process stem from several circumstances. The regulations prevent OPSC from examining the amount of funds available from other revenue sources. OPSC is strictly limited to reviewing funds available in capital outlay accounts and is prohibited from examining other fund accounts that also can be used by school districts for construction funding. School districts have recognized this loophole and have transferred capital project funds from their capital outlay accounts to other accounts that cannot be included in the OPSC review process. For example, an applicant from a large school district transferred $4,000,000 from its general fund to its Special Reserve fund (non-capital outlay) in FY 04-05 for the purpose of avoiding OPSC review of that available funding. The money could not be considered by OPSC as available for facility construction because it was transferred to a fund account that OPSC could not include in its review. The school district previously performed a similar funds transfer in FY 03-04 for $3,000,000, and again this money could not be considered by OPSC as a possible contribution to the project. The State provided full funding to the applicant for its facility construction project.

In another example, a large school district had previously been denied financial hardship status by OPSC on its last two applications because OPSC had determined that the applicant had sufficient funds available to meet the 50 percent contribution requirement. On its third attempt to receive financial hardship certification, the school district transferred its capital outlay funds to its general fund. Because OPSC staff could not review the funds in the General Fund, the school district was subsequently approved for financial hardship funding and was not required to contribute any local funds to the construction projects within this application.

A second area of concern is the regulation that calls for school districts to have at least 60 percent debt in order to qualify for financial hardship certification, which has led school districts to incur unnecessary loans from financial institutions. For example, one school district had withdrawn its application after learning that it would not meet the 60 percent indebtedness requirement imposed by the Program to help quality for financial hardship certification. The school district subsequently obtained a loan -- Certificate of Participation (COP) -- and reapplied for financial hardship certification. Due to the COP issuance, the school district met the 60 percent indebtedness requirement and qualified for full financial hardship funding. Additionally, the school district was not required to contribute funds to the approved construction projects contained within their application.

A third area of concern is that the financial review process does not restrict the types of information sources that can be submitted with a school district's application. There were many instances in which school districts submitted financial data on sheets of paper, Excel data tables, and other miscellaneous documents that did not ensure the reliability or the accuracy of the data that was submitted. Of the 15 applications that we reviewed, ten contained errors and other omissions in the capital outlay fund data that was submitted to OPSC. Similarly, in eight of the 15 applications, school districts double counted or presented other data discrepancies that occurred on the forms used by OPSC for their review. In one case that double counting occurred, one rural school district was required by OPSC to contribute 48 percent of its available funding to its construction project because the school district reported that it had more funding than was actually available. Due to the complexity of the form required by the Program, data inaccuracies were undetected by OPSC staff. To identify these errors, an OPSC reviewer must be experienced and have expertise in auditing and accounting. Currently, OPSC has had high staff turnover and does not require staff auditors to have these critical qualifications. Given our concerns about the accuracy of the data submitted by the school districts, we could not determine whether the funding contribution amounts recommended by OPSC were accurate.

Finally, our evaluation identified concerns about the manner in which OPSC staff auditors implement the Financial Hardship Program process. For instance, the process does not include procedures for OPSC reviewers to raise difficult or complex issues to senior or executive management. Also, the process does not require OPSC reviewers to sufficiently document the activities performed as part of their reviews of the school districts' applications.

Other California funding agencies, such as the California Educational Facilities Authorities, utilize different models for allocating funds to agencies and organizations in need by assessing the overall fiscal health of an applicant to determine eligibility for State funding. Working groups are established comprised of executive management, managers, supervisors, staff, and independent members to review and validate the analysis performed by staff. Agency officials reported that the outcomes of these reviews have mitigated disagreements about the results of the review processes.

We recommend to OPSC that it should revise its current Financial Hardship Review model to evaluate the overall fiscal health of the applicant rather than limiting the review to available funds in capital outlay fund accounts. To accomplish this recommendation, OPSC needs to take the following actions:

1. Establish an advisory panel comprised of Legislative Analyst Office (LAO) and Department of Finance representatives to prepare the framework for the revised model. Once established, the advisory panel will need to address the following issues:

    a. Propose revised Financial Hardship Program regulations to review the overall fiscal health of the applicant.
    b. Establish key fiscal health ratios to be submitted by the applicant that show revenue availability, debt levels, liability levels, and operating margins. The financial ratios should be based on the most recent year-end audited financial statements and a current trial balance report.
    c. Develop an index of State and application contribution levels based on the fiscal health assessment of the applicant.

d. Approve OPSC revamped Financial Hardship Program instructions that provide guidance to the applicants on the financial hardship certification program and funding allocation process.
e. Establish performance requirements for the review of financial hardship certification applications upon submission of complete applications. (e.g., 30 or 60 days).
f. Determine whether applicants should submit financial hardship certifications for each project effectively eliminating the six-month effective period of the certification.
g. Seek an independent firm or expert to determine whether vulnerabilities exist within the revised model.

2. Establish a formal training program for prospective applicants to be administered once a year. This training program should include information pertaining to the application receipt, processing and decision-making criteria used by OPSC reviewers.

3. Develop policies and procedures that trigger OPSC mid-level and/or executive management resolution of issues raised by an applicant or by the OPSC reviewer's analysis of the financial hardship application. These triggers could include the identification of excessive fund transfers to the applicant's general fund, restrictions found on certificates of participation, a school district's utilization of legal services, and issues that require interpretation or application of regulations.

4. Revamp the Financial Hardship Certification Application to reflect the revised review model, including updating instructions for each financial worksheet required.

5. Add a component to the Financial Hardship Review Process to require OPSC reviewers to visit school districts when circumstances are warranted. These circumstances can include unclear financial information, discrepancies found in the financial data, or the absence of supporting documentation on the financial hardship application.

6. Restrict access to information systems so that upon completion of the review of an application, the record cannot be overwritten with information from another application.

7. Implement information system-edit checks to require OPSC reviewers to enter required database information.

8. Add system tables to perform and validate matching share contribution calculations.

9. Require mid-level managers to provide bi-monthly performance monitoring on key performance metrics, such as the timeliness of the review process, adherence to internal controls and review outcomes of the financial hardship review process (e.g., percent of withdrawals, denials, and approval rates).

10. Establish an advisory panel comprised of LAO, Department of Finance representatives, OPSC mid-and executive-level management, and an independent auditor that meets monthly to validate the results of the financial hardship certification review and provide approval of eligibility and funding contributions.

**Cost analysis**

To assist OPSC in determining the cost benefit of implementing a revised model for determining financial hardship funding levels, we determined that most of the recommendations and activities can be carried out by OPSC staff. The amount of staff time and resources required are excluded in this cost analysis. We anticipate that at least six months are needed to address the recommendations.

Anticipated Expenses:

- Hiring of independent firm to validate the integrity and validity of the revised program – $25,000. (one time cost)
- Hiring of independent firm to validate the results of Financial Hardship Program Application review results – $2,500 to $8,000.
- Development of training sessions to familiarize school districts with applying to the revised Financial Hardship Program – $25,000.

Total anticipated direct expenses – $55,000.

To estimate the potential impact on funding contribution levels if OPSC updates its model to assess the overall fiscal health of school districts, we assigned them a five percent contribution obligation. This five percent benchmark is used to identify materiality of data according to generally-accepted government auditing standards. For the purpose of analysis only, we applied five percent to the total available funding amounts for each of the applications in our pool of school districts, as well as applying the five percent benchmark to the estimated costs of facility construction to derive at a possible contribution amount for the applicant. Table 1 below shows the possible contribution levels if the OPSC were to set amounts based on total available funds or on the estimated construction cost of the project. The results show that five of the six smaller school districts would contribute less of their own funds to the project if the requisite shares were based on the total available funds from the school district. In contrast, five of the eight applicants from larger school districts would contribute more of their available funds to pay for the construction project.



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We further analyzed how the contribution allocation would change if OPSC opted to take the lesser amount (Table 2) that was calculated based on five percent of total available funds and five percent of estimated project costs. The results show that all seven larger school districts would provide greater levels of funding than what was originally required by the Financial Hardship Program; two of the six smaller districts would also provide greater levels of funding; and the contribution levels other smaller districts would be reduced. Figure 1.0 and Figure 2.0 for the differences in contribution levels.

**Table 1.0: Comparison of Funding Contribution Amounts.**

| School District | Total Available Funds | Contribution Amount based on 5% of Available Funds | Total Estimated Project Cost | Contribution Amount based on 5% of Total Estimated Project Cost |
|---|---|---|---|---|
| Large Urban | $28,531,460 | $1,426,573 | $40,636,137 | $2,031,806 |
| Medium Urban | $39,227,064 | $1,961,353 | $42,843,115 | $2,142,155 |
| Medium Urban | $13,939,228 | $696,961 | $7,141,175 | $357,058 |
| Large Urban | $29,276,995 | $1,463,849 | $6,457,961 | $322,898 |
| Large Urban | $31,873,342 | $1,593,667 | $15,880,337 | $794,016 |
| Medium Urban | $10,235,591 | $511,779 | $2,858,162 | $142,908 |
| Medium Urban | $10,526,652 | $526,332 | $2,085,580 | $104,279 |
| Rural | $233,113 | $11,655 | $1,721,135 | $86,056 |
| Rural | $1,467,851 | $73,392 | $1,748,362 | $87,418 |
| Rural | $1,558,219 | $77,910 | $3,162,014 | $158,100 |
| Rural | $13,221,234 | $661,061 | $10,292,300 | $514,615 |
| Rural | $329,256 | $16,462 | $696,190 | $34,809 |
| Rural | $701,729 | $35,086 | $3,538,030 | $176,901 |
| **Total** | | **$9,056,087** | **$139,060,499** | **$6,953,025** |

**Table 2.0: Differences in Contribution Levels for School Districts using Another Model versus the Current Program Structure**

| School District | Estimated School District Contribution Amount | Original OPSC Determined Contribution Amount | Difference |
|---|---|---|---|
| Large Urban | $1,426,573 | $0 | $1,426,573 |
| Medium Urban | $1,961,353 | $0 | $1,961,353 |
| Medium Urban | $357,058 | $0 | $357,058 |
| Large Urban | $322,898 | $63,066 | $259,832 |
| Large Urban | $794,016 | $0 | $794,016 |
| Medium Urban | $142,908 | $0 | $142,908 |
| Medium Urban | $104,279 | $0 | $104,279 |
| Rural | $11,655 | $163,523 | ($151,867) |
| Rural | $73,392 | $202,293 | ($128,900) |
| Rural | $77,910 | $749,899 | ($671,988) |
| Rural | $514,615 | $0 | $514,615 |
| Rural | $16,462 | $43,633 | ($27,170) |
| Rural | $35,086 | $0 | $35,086 |
| Totals | $5,838,210 | $1,222,414 | $4,615,796 |

**Figure 1.0: Estimated Contribution Amounts Provided by School District Using a Different Funding Model**

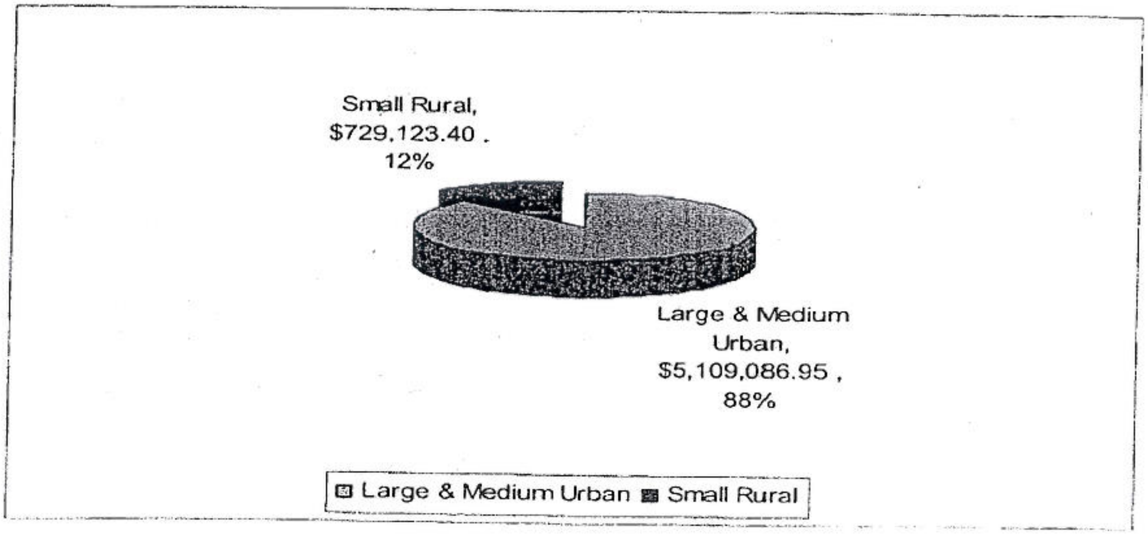




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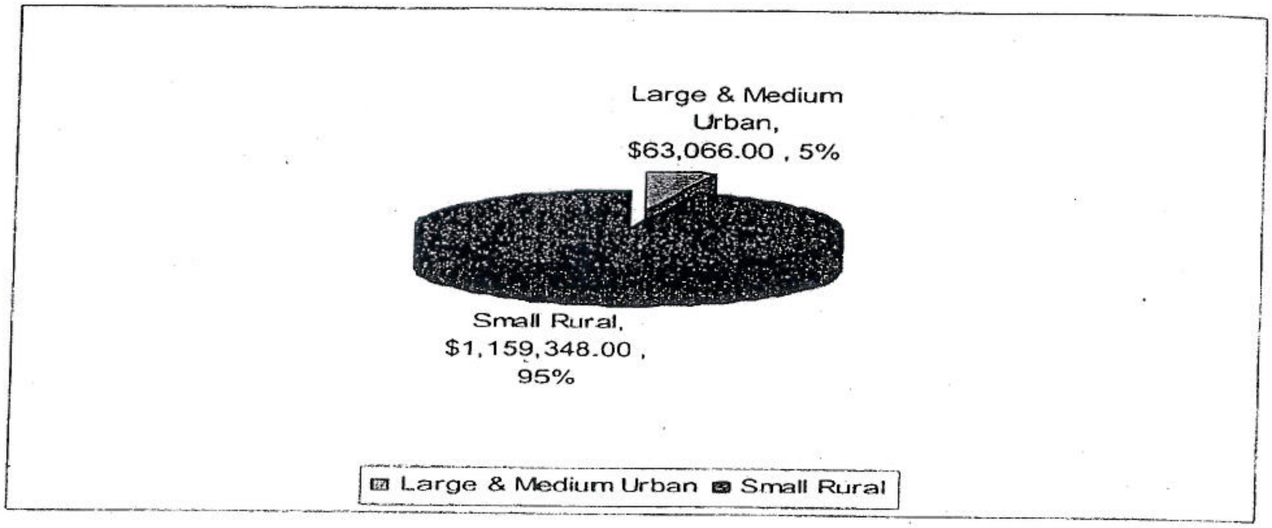
**Figure 2.0: Contribution Amounts Provided by School District Under the Current Financial Hardship Program**



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## ATTACHMENT C

**Work Plan for Improving the Financial Hardship Program**

### Executive Summary

The Office of Public School Construction (OPSC) contracted with the Macias Consulting Group (MCG) to conduct a performance audit of the Financial Hardship (FH) Program. The Macias consultants provided a number of recommendations to improve the program:

1. Revamp the FH framework.
2. Establish training for applicants.
3. Develop and implement program policies.
4. Revamp worksheets and instructions.
5. Establish information system safeguards.
6. Implement process improvements and training.

The OPSC will execute this work plan to implement these recommendations. Adoption of several recommendations is complete or underway, but the full complement of recommendations will take several months and approximately $97,000 in one-time costs and $44,000 in on-going costs to implement. These changes will streamline and simplify the FH review process for OPSC customers, improve the integrity of the program, and ensure an equitable distribution of hardship funding to qualifying school districts.

### Recommendation #1: Revamp FH Framework

Recommendations:

Establish an advisory panel comprised of Legislative Analyst Office (LAO) and Office of Statewide Audits and Evaluations (OSAE) representatives to prepare the framework or the revised model. Once established, the advisory panel will need to address the following issues:

a. Propose revised FH Program regulations to review the overall fiscal health of the applicant.

b. Establish key fiscal health ratios to be submitted by the applicant that show revenue availability, debt levels, liability levels, and operating margins. The financial ratios should be based on the most recent audited financial statements and a current trial balance report.

c. Develop an index of State and application contribution levels based on the fiscal health assessment of the applicant.

d. Approve OPSC revamped FH Program instructions that provide guidance to the applicants on the FH certification program and funding allocation process.

e. Establish performance requirements for the review of FH certification applications upon submission of complete applications (e.g., 30 or 60 days).

f. Determine whether applicants should submit FH certifications for each project effectively eliminating the six-month effective period of the certification.

g. Seek an independent firm or expert to determine whether vulnerabilities exist within the revised model.

*Actions Needed for Recommendation #1:*

| | |
|---|---|
| Assemble Advisory Panel | Completed |
| Revamp FH model | Underway |
| Beta test revised model | November 2007 |
| Discuss the revised model at the Implementation Committee | December 2007 |
| Follow-up discussion at the Implementation Committee | January 2008 |
| Independent evaluation of model | February 2008 |
| Revised regulations to State Allocation Board | March 2008 |

## Recommendation #2: Establish Training for Applicants

*Recommendation:*
Establish a formal FH training program for prospective applicants to be administered once a year. This training program should include information pertaining to the application receipt, processing, and decision-making criteria used by OPSC reviewers.

*Actions Needed for Recommendation #2:*

| | |
|---|---|
| Establish Training for Applicants | June 2008 |

## Recommendation #3: Develop and Implement Program Policies

*Recommendations:*
Develop policies and procedures that trigger OPSC mid-level and/or executive management resolution of issues raised by an applicant or by the OPSC reviewer's analysis of the FH application. These triggers could include the identification of excessive fund transfers to the applicant's General Fund, restrictions found on certificates of participation, a school district's utilization of legal services, and issues that require interpretation or application of regulations.

Add a component to the FH Review Process to require OPSC reviewers to visit school districts when circumstances are warranted. These circumstances can include unclear financial information, discrepancies found in the financial data, or the absence of supporting documentation on the FH application.

Require mid-level managers to provide bi-monthly performance monitoring key performance metrics, such as the timeliness of the review process, adherence to internal controls and review outcomes of the FH review process (e.g., percent of withdrawals, denials, and approval rates).

Establish an advisory panel comprised of LAO, OSAE representatives, OPSC mid-and executive-level management, and an independent auditor that meets monthly to validate the results of the FH certification review and provide approval of eligibility and funding contributions.

*__Actions Needed for Recommendation #3:__*

| | |
|---|---|
| Establish program policies to elevate issues | Adopted Sept. 2007 |
| Establish policy for on-site reviews | Adopted Sept. 2007 |
| Establish bi-monthly performance monitoring | Adopted Sept. 2007 |
| Advisory panel to review revised program and approve FH applications | Upon adoption of regulations |

## Recommendation #4: Revamp the Application and Worksheets

*__Recommendations:__*

Revamp the FH Checklist to reflect the revised review model, including updating instructions for each FH worksheet required.

*__Actions Needed for Recommendation #4:__*

| | |
|---|---|
| Revamp the current program FH checklist | Adopted Oct. 2007 |
| Revamp the current program FH worksheets | December 2007 |
| Update the revised program FH checklist/worksheets | Available upon adoption of regulations |

## Recommendation #5: Establish Information System Safeguards

*__Recommendations:__*

Restrict access to information systems so that upon completion of the review of an application, the record cannot be overwritten with information from another application.

Implement information system-edit checks to require OPSC reviewers to enter required database information.

Add system tables to perform and validate contribution calculations for the application and final expenditure report submitted by the school district at the completion of the construction project.

*__Actions Needed for Recommendation #5:__*

| | |
|---|---|
| Establish information system safeguards for current program | January 2008 |
| Create new information program system for revised program | Available upon adoption of regulations |

## Recommendation #6: Process Improvements/Training

*__Recommendations:__*

The FH files were put together in a manner that did not provide a full audit trail of data used in completing the FH funding analysis. The FH review packages lacked cross-referencing, an index for the working papers, and there were no trail documenting when issues (e.g., high-level or policy issues) were elevated to management for recommendations.

At the time of the external management review, there were no staff members on the FH review team with outside audit experience. Staff with prior experience in accounting or financial auditing would better understand the concepts of analyzing financial data and what constitutes a complete audit. Additionally, the OPSC does not have a formal training process for new and current staff members.

*Actions Needed for Recommendation #6:*

| | |
|---|---|
| Standardize format for FH review files | Adopted Aug. 2007 |
| Transition of staff members with prior audit/accounting experience | Adopted Sept. 2007 |
| Training in accounting and financial reviews | Commencing November 2007 |

## Resources Needed:

- Contract with an outside consulting firm to review FH Program changes.

  Estimated one-time cost to assess the risk of the new program: $25,000
  Estimated one-time cost to develop training for OPSC reviewers: $8,000

- Engage an outside audit firm to perform monthly reviews with the FH Committee.

  Estimated annual cost: $24,000

- Multi-level training program for in-house staff.

  One-time cost to upgrade skill set of staff for FY 07/08: $17,000
  One-time cost to upgrade skill set of staff for FY 08/09: $38,000
  Estimated annual cost for on-going training: $20,000

- Authorize overtime over the next two months to address the FH review workload.
  One-time cost: $9,000

- Redirect and rotate School Facility Program auditors onto the FH review team.
  Estimated cost: Non-substantial

## Total Costs:

- Total estimated implementation cost for these program improvements is $141,000. This includes $97,000 in one-time costs and $44,000 in annual costs.

**EXHIBIT A**
**Scope of Work**

## PURPOSE OF AGREEMENT

This interagency agreement between Department of General Services (DGS), Office of Public School Construction (OPSC) and the Department of Finance, Office of State Audits and Evaluations (Finance), is for the purpose of acquiring professional services to assist the OPSC to develop an interim project monitoring program and to provide audit specific training to OPSC auditors.

## SCOPE OF WORK

Finance agrees to provide the following training modules and/or coordinate contract services:

1. Provide training to approximately 40 OPSC auditors. Training will be in the areas of:
    a. Generally Accepted Government Auditing Standards
    b. Professionalism
    c. How to conduct an entrance conference
    d. Developing pointsheets
    e. Overview of internal controls
    f. State fund accounting overview
    g. How to conduct internet research
    h. What is a grant audit
    i. Interviewing skills
2. Gain an understanding of the School Facility Program and the current requirements.
3. Facilitate brainstorming sessions with OPSC staff.
4. Develop an interim project monitoring program, taking into consideration:
    a. Results of the facilitated brainstorming sessions.
    b. The current requirements for construction projects.
    c. OPSC's new audit risk assessment.
    d. Current requirements for participating school districts.
    e. Best practices and known risks.
    f. Staffing and funding availability.
5. Final product will be written procedures for interim project monitoring, including audit programs or checklists needed to perform the monitoring; and approximately 21 hours of audit training for each OPSC auditor.

DGS agrees to provide the following services:

1. Work with Finance to develop a timetable for the training to be provided.
2. Require all OPSC auditors to attend the provided training.
3. Provide information regarding the School Facility Program.
4. Attend brainstorming discussions regarding program-wide issues.
5. Attend update sessions and information sessions as needed.
6. Provide input regarding audit programs and checklists.