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AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

WILLIAM THOMSON
DEPUTY AUDITOR GENERAL

June 13, 2002

The Honorable Roberta Voss, Chairman
Joint Legislative Audit Committee

The Honorable Ken Bennett, Vice Chair
Joint Legislative Audit Committee

RE: The Arizona School Facilities Board Special Research Project

The Office of the Auditor General has completed preliminary research of the Arizona School Facilities Board in response to a directive to perform a Special Research Project made by the Joint Legislative Audit Committee at its May 14, 2002 meeting. In issuing this request, the JLAC directed the Auditor General to complete a preliminary assessment of the Board's activities to identify areas for further review and limited that Special Research Project to 400 hours. This research was neither a financial nor a performance audit and was limited to addressing specific issues based on questions and materials presented to the Auditor General by legislative leadership. Most of the issues identified centered on the Board's administration of deficiency correction projects. Based on this research, auditors did not identify problems in any areas other than the Board's approach for entering into and managing its contract with Qwest Communications for equipment and wiring infrastructure needed to provide Internet connectivity at all school facilities.

Despite problems associated with this contract, nothing came to our attention that indicated statutory violations, conflicts of interest, or accounting irregularities. Further, since entering into the Qwest contract, statutory changes have been made to provide greater oversight and control of the Board's actions. Based on this preliminary work, we believe that further research by the Office of the Auditor General is not warranted. However, due to the demonstrated limitations in the Board's ability to adequately monitor the Qwest project, we recommend that the JLAC direct the Auditor General to conduct bi-monthly reviews of the Board's actions on the Qwest contract for the next 18 months to determine if the Board is managing the remainder of this project appropriately.

In a June 4, 2002 letter, the Governor formally requested that the JLAC direct the Office of the Auditor General to conduct an audit of the School Facilities Board contract with Qwest.

Additionally, we have had discussions with the Attorney General regarding the possible use of our staff, who have gained knowledge of the School Facilities Board through this project. Our involvement would be limited to assisting their office in the portion of their investigation that focuses on the Board's contract with Qwest.

This letter contains a brief summary of the Board's activities, the results of preliminary research into issues identified by legislative leadership, and three recommendations intended to help the School Facilities Board address problems it currently faces.

Background

The Board was created in 1998 and administers three funds to provide capital funding for K – 12 school districts in Arizona.

- The **New School Facilities Fund** provides funding to school districts to build new K – 12 school facilities. Revenues in this fund come from a direct transfer of transaction privilege tax revenues from the State Treasurer. When authorized by the Legislature, the Board may also issue revenue bonds to provide funding to school districts for new school facilities.¹ Monies are distributed to school districts as work is completed on approved projects. Since the Board's inception through May 1, 2002, the Board had paid approximately \$632 million to school districts for work completed. This work included 63 completed new school facilities, 34 new school facility projects currently under construction, and 74 new schools that are currently in the design phase (see Attachment 1 for more information).
- The **Building Renewal Fund** is used to help school districts pay for maintaining the adequacy of existing school facilities. Monies from the fund are distributed to school districts for major renovations and repairs, upgrades intended to extend the life of buildings, and other infrastructure costs on academic buildings owned by a district. Revenues in this fund come from transaction privilege tax revenues transferred directly to the fund by the State Treasurer. Since the Board's inception through May 1, 2002, the Board has distributed approximately \$342 million to school districts from this fund (see Attachment 2 for more information).

¹ A.R.S. §15-2004-2006, added by Laws 2002, Chapter 330 §35, will allow the Board to acquire new school facilities by entering into lease-to-own transactions. These laws will be effective in August 2002.

- The **Deficiencies Correction Fund** provides funding to school districts to bring their school facilities up to minimum standards established by the Board. Deficiency correction projects include both square footage deficiencies and quality deficiencies. Square footage deficiencies exist when a school district does not have the required number of square feet per student according to the formula established in statute. A quality deficiency exists when the district is unable to comply with the Board's established facility adequacy guidelines. Quality deficiencies may include deficiencies in areas such as the school site, lighting, air quality, food services, and technology. A.R.S §15-2021 requires the Board to review and award the monies to correct deficiencies by June 30, 2001, and to correct all deficiencies by June 30, 2003.

Revenues in this fund come from bond proceeds, transaction privilege tax revenues (including Proposition 301 revenues), and federal school renovation grants. As of May 1, 2002, the Board had authorized 6,218 projects that will cost an estimated \$1.1 billion. Of these projects, 632 have been completed, 1,077 are under construction, 1,145 are in the bid process, and 3,167 are in the design phase. There are also 197 projects currently on hold. Actual expenditures from this fund total approximately \$268 million since the Board's inception through May 1, 2002 (see Attachment 3 for more information).

Although the Board may issue revenue bonds for both new school facilities and deficiency corrections, to date the Board has only issued bonds for deficiency corrections. A.R.S. §§15-2063 and 15-2092 require the Board to have a certified public accountant perform an annual audit of its bond proceeds. The first audit of these bond proceeds is required to be completed by September 30, 2002. Audits completed in accordance with these statutes are to be submitted to the Office of the Auditor General for review. Because of this Office's familiarity with the Board's activities gained through this Special Research Project and our recommended continued involvement, the Legislature should consider amending these statutes to require the Office of the Auditor General to serve as the Board's required auditor.

Preliminary Research

Since the May 14, 2002 JLAC meeting, research has concentrated on the seven questions outlined below. Some of these questions were posed directly from legislative leadership while others were developed based on materials provided by members of the Legislature. To address these questions, audit staff research has included interviewing legislators, Board employees, contractors, and concerned citizens. Additionally, staff analyzed the Board's procurement policies, purchase orders, and contractor files. The issues identified by legislative leadership and the corresponding research results are presented below.

1. What procurement rules has the School Facilities Board been required to follow?

Most of the Board's procurement occurred during 2001, at which time it was exempt from following the State Procurement Code. In reviewing the Board's meeting minutes, auditors found that the Board discussed adopting procurement rules modeled after the school district procurement code at its April 12 and May 3, 2001 meetings, but it never formally adopted any procurement rules. However, based on a preliminary review of the Board's contracts bid after April 12, 2001, it appears that the Board was abiding by the school district procurement rules in practice until it became subject to the State Procurement Code on January 1, 2002.

2. Have there been any conflicts of interest when the Board has contracted with vendors to correct identified deficiencies?

A former Executive Director of the School Facilities Board resigned his position effective May 3, 2002, due in part to concerns with a relationship he had with a vendor contracted by the Board to provide educational software to all school districts in Arizona. Auditors have conducted over 30 interviews of legislators, past and present Board employees, concerned citizens, and contractors, and aside from this instance, auditors have not identified any potential conflicts of interest associated with any Board contracts.

Auditors have compiled two listings that detail information on deficiency corrections projects that have been procured by the Board. The first listing titled "[Deficiency Corrections Contracts Bid by the School Facilities Board](#)" lists project management firms and the vendors they are responsible for supervising. The list also details the school districts each vendor is working on and the total contracted amount. The second listing, titled "[Principals for Project Management and Vendors](#)" identifies the principals for each project management firm and non-government vendors. This information will be posted on the Office of the Auditor General Web site at www.auditorgen.state.az.us/research.htm on or before July 1, 2002.

3. Have the Board's procurement/bid processes been subject to an unusually high number of protests?

No, it does not appear that the Board has received an unusually high number of bid protests. Since the Board's inception, it has received only 17 bid protests, all of which were related to deficiency correction projects. As of June 11, 2002, the Board has bid over 1,700 such projects.

Auditors reviewed four bid protests and determined that the Board followed procedures outlined by the State Procurement Office for reviewing and resolving bid protests.

4. Has the Board completed and adopted minimum standards for all school facilities as required in statute?

Yes, the Board has completed and adopted minimum standards for all school facilities as required in statute. A.R.S. §15-2011(F) required the School Facilities Board to adopt minimum school facility adequacy guidelines no later than April 30, 1999. At a minimum, the Board was required to adopt standards in areas such as the following:

- School sites
- Classrooms
- Libraries and media centers, or both
- Cafeterias
- Auditoriums, multipurpose rooms, or other multiuse spaces
- Technology
- Transportation
- Facilities for science, arts, and physical education

The Board adopted minimum standards in its administrative rules on September 2, 1999. Auditors reviewed these standards and found that they addressed all minimum standard elements that statute required the Board to establish.

Since the Board originally adopted its minimum standards in 1999, it has amended them twice; however, current statute prevents the Board from making further substantial changes to these standards. First, in March 2001, the Board developed minimum standards for energy efficiency and amended its technology standards. Next, in June 2001, the Board adopted standards for equipment in libraries and media centers, classroom temperature, outdoor play surfaces, and transportation capacity.

The Board also intended to make additional changes to its technology standards in December 2001; however, in November 2001, the Legislature amended the Board's statutes and removed the Board's ability to make further amendments to its minimum adequacy standards.²

² Effective in August 2002, the Board will be able to make changes to the minimum facility adequacy standards that are necessary to meet new fire or building codes, or if the changes to the standards will save the State money.

5. Were the minimum standards used as a benchmark to assess existing facilities to determine any deficiencies?

Yes, the minimum standards were used as a benchmark to assess existing facilities to determine any deficiencies. Auditors reviewed a sample of five deficiency assessments and found that the Board used its established minimum standards as a benchmark when assessing existing facilities for deficiencies. Furthermore, each school district received a copy of the completed deficiency assessments for their review, and the Board ensured that each district was in agreement with the identified deficiencies.

6. Has the Board established a reasonable method for contracting and managing deficiency correction projects?

Yes, the Board has established a reasonable method for contracting and managing deficiency correction projects. The Board's method for ensuring that all deficiency corrections are made appropriately appears reasonable given the magnitude of the Board's workload. The Board is only authorized 27 full-time positions. However, as noted previously, as of May 1, 2002, the Board had approved 6,218 deficiency correction projects. Of these projects approximately 3,000 have either been awarded or are in the bid process. The Board's method largely relies on contractors, hired by both the Board and school districts to plan and carry out the projects under the supervision of the Board's project supervisors.

After it had established minimum adequacy standards, the Board began assessments of school facilities with the assistance of a contractor. This process identified deficiency corrections that needed to be performed to bring school facilities into compliance with the Board's minimum standards. Following completion of the deficiency assessments, architects and engineers under contract with school districts determine the technical specifications of the work required to bring each school facility into compliance with the minimum adequacy standards. Once the architects and engineers outline the technical specifications, project supervisors, employed by the Board, review them to ensure that they will bring the deficient facility into compliance for that particular standard.

The Board combines projects into packages and assigns a project management firm to administer these packages. There are currently nine project management firms under contract with the Board. Packages may be based on a number of deficiency correction projects in a geographic area or a set of projects that require a certain kind of expertise, such as roofing. The assigned firms select a project manager from their staff to administer the day-to-day operations of completing the project. These project managers solicit bids and work with the school districts' architects and engineers to review bids. The school districts' architects and engineers issue a letter of recommendation to the Board recommending the

qualified bidder who submitted the lowest price. The Board's procurement staff reviews the bid process to ensure that the qualified bidder who submitted the lowest bid is recommended to the Board. The Board must give final approval for all contract awards.

7. Did the Board properly procure its contract with Qwest Communications for equipment and wiring infrastructure needed at all schools for Internet connectivity? Has the Board managed this contract properly?

When the Board entered into the contract with Qwest Communications, it was not exempt from following the State Procurement Code, and should have competitively bid this contract. Shortly after that, the Legislature passed a law that exempted the Board from the State Procurement Code retroactively, and therefore, the method used by the Board to procure the contract is permissible. Moreover, while the Board's normal deficiency correction process seems reasonable, the Board's arrangement with Qwest did not follow the Board's standard procedures and auditors have identified several problems with the Board's management of the project. First, the Board did not assess the needs of school districts, determine the estimated costs of providing equipment and infrastructure to make all schools Internet-ready, or negotiate a fixed price for completing the project prior to issuing a \$100 million purchase order to Qwest Communications. Second, after the Board issued the purchase order, it allowed Qwest to perform the assessments and other activities which are normally performed by an independent third party contracted by the Board. Third, rather than competitively bidding the project, the Board used existing State contracts. However, State contracts negotiated by the State Procurement Office are not intended for projects of this magnitude. Further, when the Board purchased cabling services from Qwest, it used the terms of a State contract in which Qwest was not the authorized vendor. Fourth, the Board currently lacks the expertise and the information necessary to determine if the Qwest's billings are appropriate. Finally, the Board paid Qwest for travel expenses in a manner that was not consistent with State contract requirements.

No initial assessments performed—On February 1, 2001, the Board members approved a purchase order, not to exceed \$100 million, for Qwest Communications to install equipment and wiring infrastructure necessary for all school facilities in Arizona to have Internet connectivity. However, the Board did not perform any initial assessments to determine the school districts' needs, estimate the likely cost to complete this project, or negotiate a fixed cost. In fact, on the same day it approved the purchase order, the Board approved a supplemental set of technology standards, specific to the Qwest purchase order. These additional standards address items such as connection speed and capacity but were never codified in the Board's standards outlined in rule. Board staff indicate that a former executive director was solely responsible for this project and are not able to document or explain why \$100 million was an appropriate amount for the initial purchase order.

On May 17, 2002, Qwest informed the Board that it would not begin work on any new projects. Qwest stated that finishing the projects it had already started would require it to exceed the original \$100 million purchase order. Qwest also informed the Board that current work on projects would continue until the specific phase of work was completed, but that the next phase would not begin. On May 23, 2002, Qwest informed the Board that it would need an additional \$80 million to finish wiring all school facilities in Arizona for Internet connectivity. Qwest reports that as of June 11, 2002, 525 facilities had been completely wired, wiring was in process at 329 facilities, and Qwest has yet to begin wiring at approximately 628 facilities.

The Board allowed Qwest to largely set the scope of its own contract—The Board allowed Qwest to not only provide the equipment and infrastructure to make all schools Internet-ready, but to conduct the activities that determined the extent and cost of those services. In the Board's other deficiency corrections projects, minimum standards were developed and assessments were conducted before the projects were bid for a fixed price. The persons performing the assessments were separate from the contractors bidding to perform the work. However, in this project, the Board allowed Qwest to assist in the development of the design guidelines that were to be used to assess individual school needs. Once these guidelines were established, the Board allowed Qwest to perform all the assessments. In addition, the Board allowed Qwest to prepare the design plans to bring each facility into compliance with the Board's minimum adequacy standards for technology. Even though a consultant hired by the Board later reviewed the design plans and a former executive director approved them, the design plans were based on the guidelines and assessments that Qwest had performed. Finally, this contract allowed Qwest to make significant equipment purchases before assessments were completed and before the design plans were approved by the Board. In one instance, Qwest purchased approximately \$35 million worth of equipment for the project from a subcontractor, who had also been involved in preparing the design guidelines and plans. This single equipment purchase constituted over one-third of the original \$100 million purchase order, but much of this equipment is still in storage waiting to be installed.

State contracts are not intended for projects of this magnitude—Piecing together existing State contracts to construct and support high-speed local area networks to provide Internet access to the schools was not an appropriate use of these contracts. The contracts that had previously been established by the State Procurement Office with Qwest were not negotiated with a project of this type or magnitude in mind. Instead, they are intended to help State agencies make purchases for smaller projects without having to go through the bid process and to gain economies of scale that would not otherwise be available to them. Additionally, auditors found that the Board used the terms of an existing State contract to

purchase cabling communication systems from Qwest; however, Qwest was not an authorized vendor on this contract.

While the Board did negotiate discounted prices from the existing State contracts, given the magnitude of this project, they may still have received a better price if they had received competitive bids for the entire project. Bidding the project would have also established a fixed price for a network meeting the Board's technical specifications. Adjustments to the technical specifications could then have been considered if the network was too costly to install and maintain.

Board cannot evaluate appropriateness of many Qwest billings—The Board currently lacks the expertise and the information necessary to determine if many of Qwest's billings are appropriate. To date the Board has paid Qwest approximately \$10.2 million. All of these payments were approved by a former executive director of the Board. After that executive director left, the Board staff, lacking knowledge of the contract terms and the technical expertise needed to review the billings, stopped processing payments to Qwest. The Board is utilizing a consultant to review the equipment charges, but is currently not paying anything more to Qwest for professional services and travel because it does not have a technical consultant to advise them if these billings are appropriate. The Board's inability to determine if billings are appropriate is exacerbated by the large volume of invoices and because some invoices lack sufficient detail and support. Due to the magnitude of the billings it receives and the Board's lack of a system to track and monitor invoices, it is very possible that the Board may not be able to detect billing irregularities or ensure that all billings are in accordance with State contracts. Based on a limited review of the invoices, we determined that the rates charged for professional services appear proper, but we were unable to determine the propriety of the hours charged. Therefore, it is imperative that the Board acquire the technical expertise necessary to ensure the propriety of all billings prior to payment.

Some travel claims were billed inappropriately—The Qwest contracts negotiated by the State Procurement Office required that travel expenses be charged in accordance with the State travel policy. However, for several months, Qwest charged the Board for travel expenses by increasing the price of equipment based on a school district's distance from a metropolitan area. For example, Qwest added 50 percent to the cost of equipment for jobs that were more than 151 miles from Phoenix or Tucson. Payments for travel reimbursement using this method are called "uplift charges." Travel costs were billed via these uplift charges until January 2002, at which time the Board began paying Qwest for travel reimbursements in accordance with the State policy. On May 22, 2002, the Board asked that the State Procurement Office to determine the propriety of the uplift charges. As of June 12, 2002, the State Procurement Office has not reported its findings to the Board.

Recommendations

1. The Joint Legislative Audit Committee should consider directing the Office of the Auditor General to conduct bi-monthly reviews for the next 18 months of the School Facilities Board's management of the Qwest Communications contract to determine that it is managing this project appropriately.
2. The Legislature should consider amending A.R.S. §§15-2092 and 15-2063 to require the Office of the Auditor General to serve as the School Facilities Board's auditor.
3. To help it determine the appropriateness of Qwest Communication billings for professional services and travel costs, the School Facilities Board should do the following:
 - a. Hire a professional consultant who can help the Board evaluate, on a technical basis, if charges submitted to the Board by Qwest Communication are reasonable and necessary.
 - b. Require Qwest Communications to provide detailed information in an electronic format of all professional services and travel claims. This information should itemize Qwest's billings by project code, date, and employee.

If you have additional questions, please do not hesitate to contact me or Jay Zsorey, Financial Audit Manager, at (602) 553-0333.

Sincerely,

Debra Davenport
Auditor General

Enc: 3

cc: Joint Legislative Audit Committee Members

The Honorable Jim Weiers
Speaker of the House

The Honorable Randall Gnant
Senate President

Mr. Logan Van Sittert, Chair
Arizona School Facilities Board

Attachment 1

**Arizona School Facilities Board
New School Facilities Fund
Schedule of Receipts and Disbursements
From Inception to May 1, 2002
(Unaudited)**

| | Authorized¹ | Actual² |
|--|-------------------------------|---------------------------|
| Receipts | | |
| Transfers from State General Fund | | \$835,000,000 |
| Transfers to State General Fund ³ | | (83,250,000) |
| Lease receipts | | <u>11,690,159</u> |
| Total receipts | | <u>763,440,159</u> |
| Disbursements | | |
| New projects | \$1,177,092,310 | \$533,285,928 |
| Land | 115,669,553 | 95,116,518 |
| Capital facility projects | 6,101,262 | 3,998,487 |
| Other payments | | <u>8,550</u> |
| Total disbursements | <u>\$1,298,863,125</u> | <u>632,409,483</u> |
| Balance | | <u>\$131,030,676</u> |

¹ Represents new school projects authorized by the Board.

² Represents monies received by the Board and paid to school districts to construct new facilities.

³ These transfers were made pursuant to Laws 2001, 2nd S.S., Ch. 4, and Laws 2002, 3rd S.S., Ch. 2, §10.

Source: Auditor General staff analysis of the New School Facilities Fund's schedule of receipts and disbursements from inception to May 1, 2002, prepared by the School Facilities Board staff.

Attachment 2

**Arizona School Facilities Board
Building Renewal Fund
Schedule of Receipts and Disbursements
From Inception to May 1, 2002
(Unaudited)**

| | Authorized¹ | Actual² |
|--|-------------------------------|--------------------------------|
| Receipts | | |
| Transfers from State General Fund | | \$412,225,300 |
| Transfers to State General Fund ³ | | (69,934,700) |
| Total receipts | | <u>342,290,600</u> |
| Disbursements | | |
| Fiscal year 1999 | \$ 75,000,000 | \$ 75,000,000 |
| Fiscal year 2000 | 82,500,000 | 82,500,000 |
| Fiscal year 2001 | 122,725,300 | 122,725,300 |
| Fiscal year 2002 | <u>62,065,300</u> | <u>61,393,207</u> |
| Total disbursements | <u>\$342,290,600</u> | <u>341,618,507</u> |
| Balance | | <u>\$ 672,093</u> ⁴ |

¹ Represents building renewal monies authorized by the Board.

² Represents monies received by the Board and paid to school districts for building renewal.

³ These transfers were made pursuant to Laws 2001, 2nd S.S., Ch. 4 and Laws 2002, 3rd S.S., Ch. 2, §10.

⁴ Balance was subsequently distributed to school districts based on the building renewal formula, on May 31, 2002.

Source: Auditor General staff analysis of the Building Renewal Fund's schedule of receipts and disbursements from inception to May 1, 2002, prepared by the School Facilities Board staff.

Attachment 3

**Arizona School Facilities Board
Deficiencies Correction Fund
Schedule of Receipts and Disbursements
From Inception to May 1, 2002
(Unaudited)**

| | Authorized ¹ | Actual ² |
|--|-------------------------|----------------------|
| Receipts | | |
| Transfers from State General Fund | | \$235,000,000 |
| Transfers to State General Fund ³ | | (56,000,000) |
| Bond proceeds | | 507,354,534 |
| Interest on investments | | 77,230 |
| District refunds | | <u>284,514</u> |
| Total receipts | | <u>686,716,278</u> |
| Disbursements | | |
| Emergency deficiencies | \$ 20,432,932 | \$ 16,821,785 |
| Space deficiencies | 37,355,442 | 27,376,339 |
| Crisis deficiencies | 18,250,010 | 10,997,131 |
| Project deficiencies | 801,452,053 | 122,900,103 |
| Equipment | 58,000,000 | 45,750,131 |
| Qwest | 100,000,000 | 10,193,297 |
| Cox | 27,900,000 | 6,759,520 |
| Electrical deficiencies | 15,000,000 | 6,864,473 |
| Project management | 50,000,000 | 18,269,788 |
| Debt issuance costs | | 503,892 |
| Operations | | <u>1,644,215</u> |
| Total disbursements | <u>\$1,128,390,437</u> | <u>268,080,674</u> |
| Balance | | |
| Bond proceeds | | 349,582,372 |
| Deficiency fund | | <u>69,053,232</u> |
| Total balance | | <u>\$418,635,604</u> |

¹ Represents deficiency correction projects authorized by the Board.

² Represents monies received by the Board and paid to contractors and school districts for deficiency correction projects.

³ These transfers were made pursuant to Laws 2001, 2nd S.S., Ch. 4.

Source: Auditor General staff analysis of the Deficiencies Correction Fund's schedule of receipts and disbursements from inception to May 1, 2002, prepared by the School Facilities Board staff.
