A REPORT
TO THE
ARIZONA LEGISLATURE

Performance Audit Division

Performance Audit and Sunset Review

Arizona School Facilities Board

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Debra K. Davenport
Auditor General

The **Auditor General** is appointed by the Joint Legislative Audit Committee, a bipartisan committee composed of five senators and five representatives. Her mission is to provide independent and impartial information and specific recommendations to improve the operations of state and local government entities. To this end, she provides financial audits and accounting services to the State and political subdivisions, investigates possible misuse of public monies, and conducts performance audits of school districts, state agencies, and the programs they administer.

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STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

WILLIAM THOMSON
DEPUTY AUDITOR GENERAL

August 16, 2007

Members of the Arizona Legislature

The Honorable Janet Napolitano, Governor

Mr. Frank Davidson, Chair
Arizona School Facilities Board

Mr. John Arnold, Executive Director
Arizona School Facilities Board

Transmitted herewith is a report of the Auditor General, A Performance Audit and Sunset Review of the Arizona School Facilities Board. This report is in response to a May 22, 2006, resolution of the Joint Legislative Audit Committee. The performance audit was conducted as part of the sunset review process prescribed in Arizona Revised Statutes §41-2951 et seq. I am also transmitting with this report a copy of the Report Highlights for this audit to provide a quick summary for your convenience.

As outlined in its response, the Arizona School Facilities Board accepts or agrees with all of the findings and plans to implement all of the recommendations directed at it.

My staff and I will be pleased to discuss or clarify items in the report.

This report will be released to the public on August 17, 2007.

Sincerely,

Debbie Davenport
Auditor General

Enclosure

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SUMMARY

The Office of the Auditor General has conducted a performance audit and sunset review of the Arizona School Facilities Board (SFB), pursuant to a May 22, 2006, resolution of the Joint Legislative Audit Committee. This audit was conducted as part of the sunset review process prescribed in Arizona Revised Statutes (A.R.S.) §41-2951 et seq.

The Legislature created the School Facilities Board in 1998 through legislation known as Students FIRST (Fair and Immediate Resources for Students Today). Students FIRST changed the way Arizona funds kindergarten- through 12th-grade (K-12) schools by establishing minimum adequacy guidelines for facilities to meet and providing state funding to ensure all school districts' facilities comply with the guidelines. Previously, Arizona's school construction funding system relied on property taxes and bonding. As a result, monies available for capital facilities depended on a district's property wealth, and the quality of facilities varied greatly within the State, with some buildings being unsafe, unhealthy, and in violation of building fire and safety codes. In 1994, the Arizona Supreme Court ruled on a 1991 lawsuit and declared that Arizona's system of school capital finance did not conform to the State's Constitution, which requires the Legislature to enact laws to provide for the establishment of a general and uniform public school system. Students FIRST was enacted in response to the court ruling.

SFB is responsible for establishing minimum adequacy guidelines and managing four funds to ensure that school facilities and equipment meet the guidelines. Specifically:

- The **Deficiencies Correction Fund** provides funding to school districts to bring their facilities up to the established minimum adequacy guidelines. Statute required all deficiencies to be corrected by June 30, 2006. According to SFB's Executive Director, as of June 2007, only one district was still working to finish its deficiency projects. As of April 10, 2007, SFB had expended approximately $1.3 billion from this Fund.

- The **New School Facilities Fund** provides kindergarten- through 12th-grade school districts with monies to purchase land and build new school facilities to accommodate student enrollment growth. As of June 7, 2007, SFB had

awarded 328 new school projects with a total value of approximately $2.78 billion, and as of May 31, 2007, it had distributed $1.9 billion in progress payments to districts for their projects.

- The **Building Renewal Fund** provides school districts with monies to help them maintain the adequacy of existing school facilities. In fiscal year 2006, SFB distributed $71.3 million to districts from this Fund.

- The **Emergency Deficiencies Correction Fund** provides school districts with monies to help them manage needs that threaten their functioning, preservation or protection of property, or public health, welfare, or safety. From fiscal years 1999 through 2006, SFB awarded 14 emergency correction projects with a total value of $8.4 million.

Future new school construction costs will place increasing demands on General Fund (see pages 15 through 22)

Arizona's choice to pay for new school construction from the General Fund makes it particularly important for the Legislature to be aware of projected new school facilities construction costs. The New School Facilities program provides K-12 school districts with monies to purchase land and construct new school facilities to accommodate student enrollment growth. Rising construction costs and rising student enrollment are projected to create a need for new construction expenditures totaling $2 billion to $2.4 billion between fiscal years 2008 and 2012. Under the current funding mechanism, the total amount will have to come from the General Fund because other sources of revenue used in previous years will be exhausted by fiscal year 2008.

Further, SFB's interpretations of minimum adequacy guidelines will potentially increase the impact on the General Fund under the current funding mechanism. A.R.S. §15-2041 allows SFB to distribute money in excess of a statutory formula amount to accommodate inflation, based on an index identified by the Joint Legislative Budget Committee (JLBC), and other specified factors. SFB's additional awards totaled $31.8 million in fiscal year 2007. Although SFB staff explained that the awards are necessary to allow districts to build schools comparable to those built in previous years, the additional awards are not based on an inflationary adjustment allowed by statute and therefore may exceed SFB's statutory authority. To determine if its actions are within the scope of its authority, SFB should seek a formal Attorney General opinion and then follow the Attorney General's advice.

Building renewal formula may need modification (see pages 23 through 30)

The Legislature should consider modifying the school district building renewal funding formula to help districts better manage their building renewal monies. The Legislature has not used the formula to determine funding levels in recent years and has several times passed bills with changes designed to make the formula more workable. The Governor has vetoed these changes, citing concerns from a pending lawsuit, which awaits a final court order. In June 2007, the Legislature established a task force to review and make potential recommendations to change the building renewal formula.

Formula-based amounts for fiscal years 1999 through 2007 would have totaled $1.2 billion, but actual appropriations totaled $606.8 million. Modifying and using the formula would help make funding more predictable for school districts. In the past, modifications studied and proposed included changing how older buildings and portables are treated, changing how replacement value is determined, and revising the assumptions for determining cost per square foot. Even without full formula funding, some districts have accumulated large balances of renewal monies, but district officials reported that the monies are needed for large future projects and to compensate for funding fluctuations. Although most districts' balances are $250,000 or less, six districts have accumulated balances between $3 million and $8 million.

The statutorily prescribed formula, based on a well-known formula created by two facilities management experts, is used by other Arizona agencies, and the Legislature has studied its use for those agencies. In 2000, a Joint Legislative Study Committee examined the formula's use for the Arizona Department of Administration, the Board of Regents, and the Department of Transportation, and found that the formula provides adequate support for state building renewal needs and should be adequately funded to avoid long-term costs of deferred maintenance. However, the study did not examine the formula's use for school districts.

SFB should improve oversight of districts' use of building renewal monies (see pages 31 through 36)

SFB should improve its oversight and reporting of Building Renewal Fund expenditures. As prescribed by statute, Building Renewal Fund monies are restricted for specific purposes. To comply with reporting requirements, districts must submit two building renewal reports to SFB every year: a plan and an expenditure report. The plan includes a list of projects and their expected costs for each school in the district. SFB staff review the plans to ensure the planned projects meet statutory requirements and estimated costs appear reasonable. SFB staff did not start reviewing the expenditure reports in depth until the Office of the Auditor General began this audit. According to SFB management, there has always been some level of review of building renewal expenditures, but they were not able to provide evidence of their review or extent of it.

Both auditors and SFB staff identified instances of school districts inappropriately using building renewal monies. Based on their descriptions in districts' fiscal year 2005 expenditure reports, 193 expenditures totaling approximately $4 million of the $40.6 million reported expenditures appeared to be potentially inappropriate uses for building renewal monies. For example, the reports showed expenditures for new construction, land improvements, and irrigation. Based on an in-depth review of 8 of the 193 expenditures, auditors determined that 6 of the 8 expenditures did not meet statutory criteria for approved uses of building renewal monies. Auditors also identified inappropriate building renewal expenditures in a review of expenditures reported in the Annual Financial Reports (AFR). Based on their descriptions in the reports, approximately $8.8 million of the $44.2 million reported expenditures appeared to be potentially inappropriate uses of building renewal monies. Based on an in-depth review of expenditures submitted by three school districts, auditors determined that some expenditures did not meet the statutory criteria for approved uses of building renewal monies. Although many of these expenditures may be appropriate, SFB staff can only speculate whether they are appropriate until they analyze them.

Although SFB staff, during the audit, began evaluating expenditures for appropriateness, they have not yet developed a standard process for this review. In addition, SFB has never reported inappropriate expenditures to the Superintendent of Public Instruction, as required by statute. Because the Superintendent would be required to withhold other monies until the inappropriate expenditures were repaid, the Executive Director does not believe it would be fair to report them without a process for the districts to challenge SFB staff's findings. SFB should develop and implement policies and procedures for its staff to review expenditure reports, allow districts to challenge its findings, and report inappropriate expenditures to the Superintendent of Public Instruction.

Controls should be improved to ensure monies paid out appropriately (see pages 37 through 41)

Although SFB has some good practices to help ensure that it appropriately manages payments for school districts' projects, it lacks a complete system of internal controls. SFB, one of the State's highest recipients of legislatively appropriated monies, pays out hundreds of millions of dollars each year for districts' projects. SFB has developed some good practices, such as requiring supporting documentation from districts to support the amounts requested and separating duties so that different employees prepare, enter, and approve payments on the State's accounting system. According to SFB's executive director, SFB staff reconciled payments data in the SFB's project-tracking database to the payments recorded in the state-wide accounting system. However, until December 2004, SFB did not retain evidence of these reconciliations. Further, SFB lacks written policies and procedures to help ensure its practices are followed consistently, and does not always use its close-out procedure, which is one of its best controls, for all projects. As a result, it has made some overpayments. Specifically, 31 out of 530 projects for the period June 1999 through November 2006 had negative balances totaling $1.7 million, indicating that expenditures may have exceeded awards. In a review of 11 of these projects that had negative balances totaling approximately $1.5 million, auditors found most negative balances resulted, in part, from recordkeeping errors, but SFB had made overpayments totaling $63,200 for 4 projects. SFB should take steps to improve its internal control policies and procedures to help ensure payments are appropriate.

Database controls need improvement (see pages 43 through 50)

In addition to improving its overall internal control framework, SFB needs to improve controls over its project-tracking database. SFB relies on the database to help manage its payments and track project information. As a result, controls are important to ensure the data is secure and reliable. However, SFB lacks some important controls, such as unique passwords for different users, and automated edit checks to ensure payments do not exceed approved amounts. A comparison of SFB practices to the internationally recognized COBIT® guidelines for information systems found that SFB only partially addresses the guidelines.

These weaknesses appear related to SFB's lack of adequate oversight of IT resources and to a contract that delegates too much authority to SFB's IT consultant. SFB needs to take several steps to improve its IT controls to help ensure schools are paid appropriately and to improve the data it uses for budgeting purposes. Specifically, SFB should improve security measures, establish written policies and procedures, and develop a formal training program. SFB should also develop and test its business continuity plan. In addition, it should modify its consultant contract to specify documentation and security requirements and to establish state ownership of the project-tracking database. Finally, it should consider the best method to meet its IT needs through the use of consultants or in-house resources.

Other Pertinent Information (see pages 51 through 53)

As part of the audit, auditors gathered other pertinent information regarding the Board's awards of monies for school districts' emergency deficiency correction projects. The Legislature established the Emergency Deficiencies Correction Fund to help districts manage serious needs in excess of their current budgets. SFB has awarded 14 projects totaling approximately $8.4 million to districts since its inception in fiscal year 1999.

TABLE OF CONTENTS

continued

TABLE OF CONTENTS

continued

TABLE OF CONTENTS

Tables:

Figures:

◆ concluded

INTRODUCTION & BACKGROUND

The Office of the Auditor General has conducted a performance audit and sunset review of the Arizona School Facilities Board (SFB) pursuant to a May 22, 2006, resolution of the Joint Legislative Audit Committee. This audit was conducted as part of the sunset review process prescribed in Arizona Revised Statutes (A.R.S.) §41-2951 et seq.

SFB history and responsibilities

The School Facilities Board (SFB) was created in 1998 by legislation known as the Students FIRST Act (Fair and Immediate Resources for Students Today). Students FIRST changed the way Arizona funds kindergarten- to 12th-grade (K-12) schools by establishing minimum adequacy guidelines for facilities to meet and providing state funding to ensure all school districts' facilities comply with the guidelines. The legislation resulted from a 1991 lawsuit filed by four school districts that alleged Arizona's school construction funding system was unconstitutional. The previous system relied on property taxes and bonding, and as a result, monies available for capital facilities depended on a district's property wealth. Thus, the quality of facilities varied greatly within the State with some buildings being unsafe, unhealthy, and in violation of building fire and safety codes. In 1994, the Arizona Supreme Court declared that Arizona's system of school capital finance did not conform to the State Constitution's Article 11, Section 1.A., which requires the Legislature to enact laws to provide for the establishment of a general and uniform public school system.

Students FIRST created SFB to ensure that school buildings and equipment meet appropriate guidelines for Arizona students to achieve academic success. To accomplish this goal, SFB was charged with establishing guidelines for school facilities and administering a deficiency correction program to bring inadequate facilities up to the guidelines by June 2003.[1] In addition, SFB is responsible for administering state monies for new school facilities construction and building renewal, and meeting facilities' emergency needs.

Students FIRST created SFB to ensure that school buildings and equipment meet appropriate guidelines for Arizona students to achieve academic success.

1 Laws 2005, 7th S.S., Ch. 287, §7, changed the deadline for completing deficiencies correction projects to June 30, 2006.

Minimum adequacy guidelines

SFB's responsibilities include creating minimum adequacy guidelines that school facilities and equipment should meet. Although Students FIRST created some guidelines, such as that buildings must be structurally sound, it charged SFB with establishing minimum adequacy guidelines for Arizona's school facilities. SFB adopted minimum school facility guidelines in its administrative rules on September 2, 1999. These guidelines include all nine elements that A.R.S. §15-2011 requires SFB to address (see textbox). Since the adoption of these guidelines, SFB has amended them twice. First, in March 2001, SFB developed minimum guidelines for energy efficiency and amended the technology guidelines. Second, in June 2001, SFB adopted guidelines for library and media center equipment, classroom temperature, outdoor play surfaces, and transportation capacity. In November 2001, the Legislature amended SFB's statutes and removed its ability to make further amendments to the minimum adequacy guidelines during fiscal years 2003 and 2004, unless the changes were necessary to comply with building health, fire, or safety codes or would reduce state costs. As of 2007, SFB has the ability to make changes to the minimum adequacy guidelines in its rules but has not recently done so.

Minimum adequacy guidelines must address:

- School sites
- Classrooms
- Libraries
- Cafeterias
- Auditoriums and multipurpose rooms
- Technology
- Transportation
- Facilities for science, arts, and physical education
- Other facilities and equipment necessary to achieve academic standards

Source: A.R.S. §15-2011.

SFB-administered funds

Statute requires SFB to manage four funds to address districts' capital needs, including the needs for new construction as well as maintenance and repair of existing facilities.

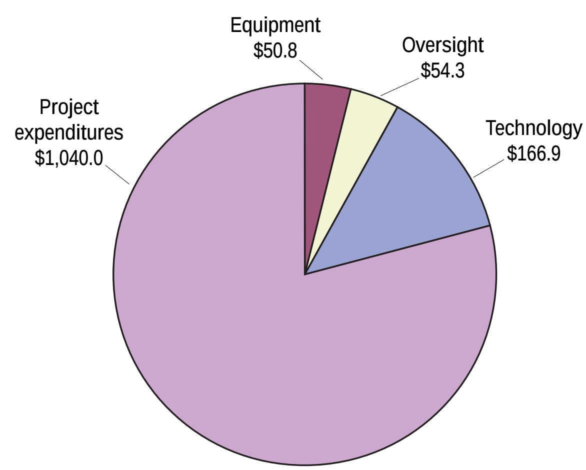
Statute requires SFB to manage four funds to address districts' capital needs, including needs for new construction as well as maintenance and repair of existing facilities. Specifically:

- The **Deficiencies Correction Fund** provides funding to school districts to bring their facilities up to the established minimum adequacy guidelines. Administration of this Fund was one of SFB's primary duties until June 30, 2006, the statutory deadline for completing correction of all deficiencies. According to SFB's Executive Director, as of June 2007, only one district was still working to finish its deficiency projects.

  Deficiency 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 a district facility does not comply with the minimum adequacy guidelines. Quality deficiencies include deficiencies in areas such as lighting, air quality, food services, and technology. To identify deficiencies requiring correction, SFB staff, with the assistance of a contractor, assessed all school facilities in the State against the minimum adequacy guidelines. Each district received a copy of its assessment, and SFB ensured that the district agreed with the identified deficiencies by reviewing them with district officials. The assessment was a one-time process, and school districts will not receive additional funds after their identified projects are complete.

As illustrated by Figure 1, as of April 10, 2007, SFB had expended approximately $1.3 billion to pay for identified deficiency projects, technology, equipment, and project oversight. This money was used for a total of 9,002 projects. SFB distributed $19.9 million from the Deficiencies Correction Fund for district projects in fiscal year 2006. As of June 30, 2006, the Fund's fund balance totaled approximately $30.3 million. Proceeds from the sale of bonds were the main source of monies for this program. (See page 6 for more information.)

Figure 1: Expenditures of Deficiencies Correction Fund Monies
As of April 10, 2007
(In Millions)



Source: Auditor General staff analysis of SFB's deficiency report, as of April 10, 2007.

- The **New School Facilities Fund** provides K-12 school districts with monies to purchase land and build new school facilities to accommodate student enrollment growth. School construction includes both building a new facility and adding space to an existing one. As prescribed by A.R.S. §15-2041, a district is eligible for funding if SFB-approved projections indicate that additional space will be needed within the next 2 years for an elementary school or within 3 years for a middle or a high school. SFB determines eligibility for funding by considering district enrollment projections, existing square footage of schools in the district, and the additional square feet that will be needed to maintain the minimum square feet per student.

The New School Facilities Fund provides kindergarten to 12th-grade school districts monies to purchase land and build new school facilities.

SFB staff calculate the amount of funding a district receives according to a formula prescribed in A.R.S. §15-2041. Specifically, to determine funding for a construction project, SFB staff multiply the number of new students who will be served times the required minimum square feet per student and a funding amount per square foot. The statute establishes the square feet per student for new construction based on grade level, ranging from 90 to 134 square feet.

Statutorily prescribed square footage and funding amount per square foot as of October 24, 2006[1]:

Grade Level	Square Footage	Amount
Kindergarten to 6th	90	$131.13
7th and 8th	100	$138.42
9th to 12th	125 or 134	$160.28
Rural schools		Add 5%

1 Amounts are adjusted annually.

Source: A.R.S. §15-2041 and JLBC minutes for October 24, 2006.

New construction awards
(As of June 7, 2007)

231 elementary schools
42 middle schools
53 high schools
4 other projects
Total $2.78 billion

Distributions
(Fiscal years 1999 through 2007)

$1.96 billion
Fiscal year 2006: $338.7 million
Fiscal year 2007 estimate: $350.6 million

Source: Auditor General staff analysis of *School Facilities Board Annual Report Fiscal Year 2005-2006,* Arizona Financial Information System (AFIS) Event Transaction file, JLBC staff analysis of fiscal years 1999 through 2006 SFB appropriations and expenditures, and information provided by SFB management.

It also establishes the funding per square foot, adjusted annually based on construction market conditions, with an additional 5 percent adjustment for school projects in rural areas (see textbox). Districts can apply for additional monies if they cannot build a school that meets minimum adequacy guidelines with the amount calculated by the formula.

As of June 7, 2007, SFB had awarded 330 new school projects with a total value of approximately $2.78 billion (see textbox). As of June 30, 2007, SFB had distributed $1.96 billion in progress payments to districts for their projects (See Finding 1, pages 15 through 22, for more information on this program). Proceeds from the use of lease-to-own agreements and General Fund appropriations are the main sources of monies for this program (See page 6 for more information on lease-to-own agreements and General Fund appropriations.)

- The **Building Renewal Fund** provides school districts with monies to help them maintain the adequacy of existing school facilities. While the deficiencies program helped bring school facilities up to the established minimum adequacy guidelines, this program helps districts maintain and extend the life of their school facilities. A.R.S. §15-2031 authorizes the use of this Fund primarily for buildings owned by the districts that are required to meet academic standards and secondarily for any other buildings owned by the districts. Examples of allowed expenditures include replacing air conditioning units and carpet and repairing roofs. SFB staff determine annual distributions based on a statutorily established formula that considers square footage, age, and student capacity of each district's buildings.

The Building Renewal Fund provides districts with monies to help them maintain the adequacy of existing school facilities.

SFB distributed $71.3 million from the Building Renewal Fund in fiscal year 2006, and SFB staff project that it will distribute $94 million in fiscal year 2007. Nearly all—187 out of 215—school districts received building renewal monies in fiscal year 2006, with the amounts per district ranging from $144 to $7.6 million.[1] The remaining 28 districts did not receive building renewal monies because they did not comply with statutory reporting requirements or because their buildings were too new to receive the monies. (See Finding 3, pages 31 through 36, for more information on this program.) General Fund appropriations are the source of funding for this program. (See revenue sources section on page 5 for more information on General Fund appropriations.)

1 For fiscal year 2006, Arizona had a total of 239 school districts. However, according to SFB staff, only the 215 districts listed on SFB's annual building renewal report had buildings that would qualify to receive building renewal monies.

- The **Emergency Deficiencies Correction Fund** provides school districts with monies to help them manage needs that threaten their functioning, preservation or protection of property, or public health, welfare, or safety. When a school district has an emergency for which it does not have adequate monies, the district may apply to SFB for monies. The district must disclose any insurance or building renewal monies that would be available to pay for the emergency.

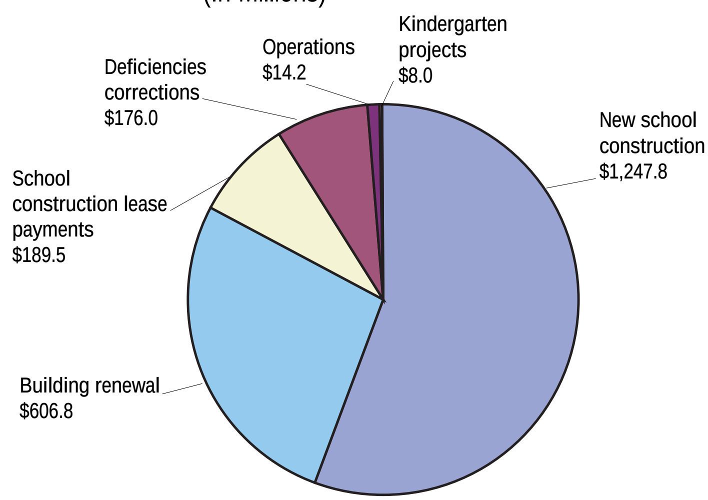
  From fiscal years 1999 through 2006, SFB awarded 14 emergency correction projects with a total value of $8.4 million. Projects paid for with emergency monies included installing a water treatment system to lower arsenic levels in an existing well and repairing roof damage caused by heavy rains. Transfers from the Deficiency Correction and New Construction Funds provide the monies for this program because the Emergency Deficiencies Correction Fund does not have a dedicated revenue source. According to SFB, its ability to assist districts with future emergency projects may be limited because the Deficiencies Correction Fund was repealed on June 30, 2006. (See Other Pertinent Information, pages 51 through 53, for more information on this program.)

Revenue sources

Several sources of revenue fund SFB's programs, including General Fund monies, bond revenues, and lease-to-own agreements. Specifically:

General Fund monies—For fiscal years 1999 through 2007, SFB received a total of more than $2.2 billion in General Fund monies, including transfers of sales taxes, to support its programs and operations.[1] As illustrated by Figure 2, more than half of the monies were appropriated to support the New Construction program, while most of the remaining monies were appropriated for school construction lease payments and for building renewal projects.

Figure 2: General Fund Appropriations by Program Fiscal Years 1999 through 2007 (In Millions)



Source: Auditor General staff analysis of JLBC's *K-12 Funding Since 1997* report dated March 14, 2007, and JLBC appropriations reports for fiscal years 1999 through 2007.

1 The General Fund appropriations amount includes direct transfers of transaction privilege tax (sales tax) revenues by the State Treasurer rather than through appropriations.

Table 1: Debt Service Requirements for Bonds
As of June 30, 2006
(In Thousands)

Fiscal Year	Principal	Interest	Total
2007	$ 47,844	$ 43,417	$ 91,261
2008	49,818	41,463	91,281
2009	52,064	39,213	91,277
2010	54,478	36,799	91,277
2011	57,289	33,987	91,276
2012-2016	334,467	121,424	455,891
2017-2021	280,697	31,014	311,711
Total	$876,657	$347,317	$1,223,974

Source: Office of the Auditor General's compliance attestation report highlights for SFB's deficiency corrections debt financing for fiscal year 2006.

Bond revenues—In fiscal years 1999 through 2006, SFB received a total of approximately $1.1 billion in bond proceeds to pay for the cost of correcting deficiencies.[1] As shown in Table 1, after principal payments through fiscal year 2006, the remaining balance is approximately $877 million, and SFB is expected to pay approximately $91.3 million per year for fiscal years 2007 through 2011 in principal and interest on these bonds. In order to provide immediate funding to correct existing school facilities' deficiencies, SFB first issued bonds in June 2001. However, because the deficiency program has ended, SFB has not issued any new bonds since August 2005.

Lease-to-own agreements—In fiscal years 1999 through 2006, SFB received a total of $900 million in lease-to-own monies to pay for new school construction. These agreements are also called certificates of participation (COPS).[2] During fiscal years 2003 through 2005, the Legislature authorized SFB to enter into lease-to-own transactions valued at $400 million, $250 million, and $250 million, respectively. These arrangements are scheduled to end in 2020. Laws 2006, Chapter 353 eliminated SFB's ability to enter into lease-to-own transactions because the Legislature intended to fund new school construction on a cash basis.

Lease-to-own—An agreement in which SFB is responsible for long-term rental and lease payments of a school facility, and has the option of purchasing the facility and transferring ownership to a school district. These agreements are sometimes called certificates of participation (COPS).

Budget

As indicated by Table 2 (see page 7), the largest sources of SFB revenues are appropriations from the General Fund, including transfers of transaction privilege taxes (sales taxes) authorized by voters through Proposition 301, passed in November 2000. From fiscal years 1999 through 2006, monies appropriated for SFB consisted of transaction privilege taxes.[3] Starting in fiscal year 2007, SFB's appropriations for all programs are strictly from the General Fund, except for sales taxes used to make bond debt service payments. In addition to its appropriations, SFB receives revenues from other sources, including remaining proceeds from lease-to-own agreements and the sale of land.

1 SFB issued a total of $1.8 billion in bonds. However, according to SFB management, some of the bonds issued were to retire older bonds, and SFB received only $1.1 billion.

2 Lease-to-own proceeds represent total net proceeds, including principal, premiums, and expenses related to their insurance.

3 Sales tax revenues are received as a result of the passage of Proposition 301 in November 2000, which increased the State's sales tax from 5 percent to 5.6 percent and dedicated a portion of the increase to pay the principal and interest on SFB's bonds. Until fiscal year 2005, A.R.S. §42-5030.01 required the Treasurer to transfer amounts directly to SFB, based on instructions from SFB, for new construction, building renewal, deficiency correction, and bonded debt service payments. Laws 2005, Ch. 287, §12 amended the statute to eliminate this provision and established that beginning in fiscal year 2007, SFB will only receive sales taxes for the payment of bonded debt service payments.

Table 2: Schedule of Revenues, Expenditures, and Changes in Fund Balance Fiscal Years 2005 through 2007 (Unaudited)

	2005 (Actual)	2006 (Actual)	2007 (Estimate)
Revenues:			
State General Fund appropriations and transaction privilege taxes[1]	$390,767,475	$518,285,272	$477,615,900
Rental income[2]	22,263,480	17,562,604	18,376,900
Interest on investments[3]	14,917,693	14,997,232	14,264,700
Loan and interest income[2]	6,967,976	4,903,390	4,767,000
Other	69	65,490	
Total revenues	434,916,693	555,813,988	515,024,500
Expenditures:			
Operating:			
Personal services and employee-related	1,673,842	1,244,673	1,322,800[4]
Professional and outside services	858,392	532,896	233,300[4]
Travel, other operating, and equipment	223,093	235,826	199,100[4]
Total operating expenditures	2,755,327	2,013,395	1,755,200
Aid to school districts:			
Payments to school districts	378,503,994	410,081,410	441,597,800[5]
Payments made on behalf of school districts	81,989,815	16,189,354	1,364,500[5]
Recoveries and repayments from school districts[6]	(15,259,497)	(1,523,638)	(4,000,000)
Total aid to school districts	445,234,312	424,747,126	438,962,300
Principal and interest payments	104,605,280	140,854,609	166,993,800
Total expenditures	552,594,919	567,615,130	607,711,300
Deficiency of revenues over expenditures	(117,678,226)	(11,801,142)	(92,686,800)
Other financing sources (uses):			
Certificates of Participation issued	261,249,496	61,867,527	17,200,000
Bonds issued	36,948,851	107,045	
Proceeds from sale of land		2,793,760	
Reversions to the State General Fund[7]	(106,887,903)		(60,080,500)
Operating transfers out[8]	(3,215,000)		(1,865,400)
Total other financing sources (uses)	188,095,444	64,768,332	(44,745,900)
Excess (deficiency) of revenues and other financing sources over expenditures and other financing uses	70,417,218	52,967,190	(137,432,700)
Fund balance, beginning of year	42,090,351	112,507,569	165,474,759
Fund balance, end of year	$112,507,569	$165,474,759	$ 28,042,059

1 Amount includes direct transfers of transaction privilege tax (sales tax) revenues by the State Treasurer. A portion of sales tax revenues is received as a result of the passage of Proposition 301 in November 2000, which increased the State's sales tax from 5 percent to 5.6 percent and dedicated a portion of the increase to pay the principal and interest on SFB's bonds.

2 Amounts consist of monies provided by the State Land Department in accordance with A.R.S. §37-521(B), which requires using the monies to pay the year's debt service on bonds before using them for other purposes. Approximately $16.4, $8.9, and $10 million was available for other uses in 2005, 2006, and 2007, respectively.

3 Amounts were used to pay debt service (principal and interest) on bonds.

4 Administrative adjustments are included in the fiscal year paid.

5 The 2007 payments to school districts includes the estimated on-behalf payments for the period March 1 to June 30, 2007, because SFB does not budget these amounts separately and could not readily estimate the remaining fiscal year 2007 amounts. The on-behalf payments for 2007 only include the actual amounts paid on behalf of school districts through February 28, 2007.

6 According to SFB management this consists of school districts payments on certain projects and unused monies returned by the school districts.

7 Amount consists primarily of monies that were returned to the State General Fund as directed by Laws 2004, Chapter 274 and Laws 2005, Chapter 287.

8 Operating transfers out were transferred or expected to be transferred to the Department of Education to provide Hayden-Winkelman Unified School District with supplemental state aid in accordance with Laws 2004, Chapter 278 and Laws 2006, Chapter 353.

Source: Auditor General staff analysis of the Arizona Financial Information System (AFIS) *Accounting Event Transaction File; AFIS Revenue and Expenditures by Fund, Program, Organization, and Object and Trial Balance by Fund* reports for fiscal years 2005 and 2006; and SFB-prepared estimates for fiscal year 2007.

Organization and staffing

SFB is overseen by a ten-member governing board including the Superintendent of Public Instruction, who does not vote.

SFB is overseen by a ten-member governing board. The Governor appoints nine voting members based on statutory criteria, and the Superintendent of Public Instruction or designee serves as an advisory nonvoting member.

During fiscal year 2006, SFB had 15 staff, including an executive director, deputy director of facilities, deputy director of finance, an architect, a demographer, 4 school facilities liaisons, and other administrative staff. SFB has 3 vacant positions; however, according to its Deputy Director of Finance, it has only enough monies to employ 15 staff. Additionally, it uses contractors to provide other expertise, including information technology and land consultation. SFB has requested additional funding for fiscal year 2008 to contract for additional information technology services, including programming and management of its network and computers, and to help ensure its operations meet state IT security standards. (For information related to SFB's data security see Finding 5, pages 43 to 50.)

9 voting members are:

- An elected member of a school district governing board
- A taxpayer organization's representative
- An individual with knowledge and experience in school construction
- A registered architect
- An individual with knowledge and experience in school facilities management in a public school system
- An individual with knowledge and experience in demographics
- A teacher
- A registered professional engineer
- An owner or officer of a private business

Source: A.R.S. §15-2001 (A).

Scope and methodology

This audit focused on the rising cost of construction and its impact on the General Fund, SFB's process for distributing and overseeing building renewal funds, and how SFB manages its funds. This audit includes five findings and associated recommendations, as follows:

- Rising construction costs and enrollment growth will place increasing demands on the General Fund, which is the sole source for new school construction monies under the current funding mechanism. SFB should seek a formal Attorney General opinion to clarify its authority to make additional awards beyond the statutory formula amount.

- To help districts better manage their building renewal monies, the Legislature should consider modifying the formula. The Legislature has not used the formula in recent years and in June 2007 formed a task force to review the formula and make potential recommendations to change it.

- SFB should improve its oversight and reporting of Building Renewal Fund expenditures to ensure the monies are used as prescribed by statute.

- SFB should improve its internal control framework to better ensure that it appropriately manages and pays out hundreds of millions of dollars annually for school projects including new school construction, deficiencies, and emergencies.

- SFB should improve controls over its project-tracking database, which it relies on to manage payments to school districts and vendors.

In addition, this report contains other pertinent information regarding how SFB has used Emergency Deficiencies Correction Fund monies (see pages 51 through 53). Also, this report contains answers to seven legislative questions regarding the design of school facilities and the accuracy of SFB's financial information (see Appendix A, pages a-i through a-v) and responses to the statutory sunset factors (see pages 55 through 62).

Auditors used a variety of methods to study the issues addressed in this audit report, including interviewing SFB staff, Joint Legislative Budget Committee staff, and Office of Strategic Planning and Budgeting staff; and reviewing SFB's budget, strategic plans, statutes, administrative rules, policies and procedures, and Board meeting minutes. Auditors also used the following specific methods:

- **Evaluating increasing costs to build new school facilities and their impact on the General Fund**—To assess the future impact of new school facilities construction costs upon the General Fund, auditors reviewed both past and projected student enrollment growth and both past and projected construction costs. Past enrollment figures were obtained from annual enrollment numbers reported by the Arizona Department of Education that are collected from school districts and then reported in aggregate numbers on the Arizona Department of Education's Web site. To determine projected student enrollment, auditors reviewed data collected and analyzed by SFB staff, who based their projections upon data received from the Arizona Department of Economic Security and the University of Arizona. To assess the impacts of past inflation on new school construction costs, auditors reviewed a report on a national survey of public owners regarding construction costs conducted by PinnacleOne and assessed an inflation index produced by Rider, Hunt, Levett, and Bailey.[1] To determine current construction costs, auditors reviewed new school construction awards and the costs associated with those awards for calendar years 2005 and 2006. To determine the expected cost to the General Fund because of enrollment growth and construction cost increases, auditors examined projected costs reported by SFB staff and Joint Legislative Budget Committee (JLBC) staff. In addition, auditors conducted interviews with ten school district officials who were questioned regarding program performance, eight school district officials who were asked questions related to funding issues,

1 PinnacleOne is a national construction consulting firm that has worked with some Arizona school districts on new school construction projects. Rider, Hunt, Levett, and Bailey is a world-wide construction consulting firm.

industry professionals such as a construction management firm project manager and SFB's staff architect, and school or finance officials in seven other states.[1] Auditors also reviewed a report on Arizona new school construction prepared by a professional association.

- **Assessing the need to study the Building Renewal funding formula**—To determine how the Legislature has funded this program, auditors reviewed appropriations reports for fiscal years 2000 through 2007 and interviewed staff with the JLBC and the Governor's Office for Strategic Planning and Budgeting (OSPB). To study the statutorily prescribed funding formula, auditors reviewed a report by the Joint Legislative Study Committee on the State Building Renewal Formula and Process and an article on the creation of the building renewal formula from the *Council of Educational Facility Planners Journal*.[2,3] In addition, auditors interviewed one of the formula's creators, William Dergis, a facilities management expert who co-developed the formula when he worked at the University of Michigan. To understand previously proposed changes to the funding formula, auditors reviewed the JLBC proposal for fiscal year 2004 and discussed the ideas in it with William Dergis. To determine the reasons districts have building renewal balances at the end of the fiscal year and to understand how building renewal funding levels affect school districts, auditors judgmentally selected four districts that had large building renewal ending balances ranging from $2.2 million to $7.6 million as of June 30, 2005. Auditors interviewed district officials in these four districts regarding the balances and reviewed supporting documents supplied by the officials, including internal capital plans and bond statements. In addition, auditors interviewed officials from three districts whose expenditures were selected as part of the review of expenditures that appeared to be inappropriate as described below, and reviewed supporting documents provided by those officials.

- **Assessing SFB's oversight and reporting of building renewal expenditures**—To determine the appropriateness of school districts' building renewal expenditures, auditors analyzed two judgmental samples of expenditures for fiscal year 2005. These expenditures were obtained from two sources: SFB's project-tracking database and the Annual Financial Reports that districts submit to the Arizona Department of Education. Specifically:

  To select school districts' building renewal expenditures for further review from the **SFB's project-tracking database**, auditors used Statistical

1 Auditors interviewed school finance officials in California, Hawaii, Nevada, New Mexico, Ohio, Texas, and Vermont. These states were selected based on their region of the country or their method of paying for school construction.

2 Laws 2000, Chapter 228, established the Joint Legislative Study Committee on the State Building Renewal Formula and Process effective until December 31, 2000.

3 Sherman, Douglas R., and William A. Dergis. *A Funding Model for Building Renewal*. CEFP Journal, Volume 9, Issue No. 3 (Jan.-Feb.1984):

Package for the Social Sciences (SPSS) Text Analysis Software to classify all 2,945 expenditures reported to SFB, and identified 193 expenditures that appeared potentially inappropriate based on their descriptions in comparison to statutes, SFB policies, and uniform standards for financial reporting. Auditors interviewed SFB's Director of Facilities regarding the 193 expenditures to obtain an understanding of the circumstances that might make these expenditures appropriate. A judgmental sample of 8 of these expenditures was selected for further analysis, based on the size of the expenditures and to represent a variety of expenditure types and school district geographic locations, including both rural and urban districts.

To identify school district building renewal expenditures for further review from the **Annual Financial Reports (AFR)**, auditors first reviewed the AFR account code descriptions in conjunction with statutes, SFB policies, and uniform standards for financial reporting. Out of 11,287 expenditures districts reported in their AFR, auditors identified 510 that appeared potentially inappropriate based on the account code they were charged to. Auditors interviewed the SFB's Director of Facilities to obtain an understanding of the circumstances that might make these expenditures appropriate. A judgmental sample of 60 expenditures was selected for further analysis based on the size of the expenditures and to represent a variety of expenditure types and geographic locations, including both rural and urban districts.

For both samples, to assess whether expenditures were in compliance with statute, auditors reviewed invoices, purchase orders, and other supporting documents provided by the districts. Auditors also interviewed district officials to obtain their explanations for how the monies were used. Auditors used this information to determine whether the expenditures were in compliance with statute. Additionally, the Office of the Auditor General's General Counsel reviewed the expenditures to determine if they were in compliance with statute based on districts' documentations and explanations. Auditors shared the results of the samples of expenditures with the SFB's Executive Director and requested his opinion on the expenditures.

- **Assessing SFB's internal controls over project payments**—To assess SFB's internal controls over its payments for school districts' projects, auditors reviewed expenditures recorded on the Arizona Financial Information System (AFIS) for fiscal years 2005 and 2006. These expenditures included payments made to county treasurers, who are responsible for distributing the monies to the school districts in their counties, and payments made directly to vendors to pay for school districts' projects. Auditors compared AFIS and SFB's project-tracking database records for fiscal year 2006 payments to county treasurers for school districts' new construction, emergency corrections, and deficiencies corrections projects, and investigated significant differences. In addition, auditors observed SFB staff performing certain payment duties. To determine whether SFB had made overpayments, auditors selected a judgmental sample of 11 out of 31 new construction projects that were active during June 10, 1999 through September 27, 2006, and had negative balances in SFB's project-tracking database, suggesting that project expenditures were higher than SFB awards, and a judgmental sample of 10 new construction and kindergarten projects that were active during June 10, 1999 through September 27, 2006, and had low balances in the database, including 5 projects with zero balances and 5 projects with balances between $1 and $10,000. For both samples, auditors compared the database information with SFB-approved budgets and supporting documentation.

- **Assessing SFB's internal controls over its systems**—To obtain an understanding of SFB's data system controls, auditors reviewed SFB's October 2005 *Business Continuity Plan*, observed SFB staff using the project-tracking database, and interviewed SFB's IT consultant and SFB officials. To determine whether SFB's project-tracking database contained errors, auditors relied on their work conducted to assess internal controls over payments. To assess internal controls over the project-tracking database, auditors compared SFB's information technology (IT) framework to guidelines published in the IT Governance Institute's Control Objectives for Information and Related Technology; evaluated compliance with selected Government Information Technology Agency (GITA) policies; reviewed SFB's list of prioritized future IT projects; reviewed SFB staff's desk procedures; and reviewed the project-tracking database input screen and data structure.[1]

- **Other Pertinent Information**—To gather information regarding SFB's awards of emergency funds, auditors reviewed board meeting minutes and packets from 1999 through 2006, an Emergency Fund Balance report dated October 10, 2006, and emergency deficiencies program policies and procedures.

- **Appendix A**—To answer legislative questions about districts' school designs, auditors sent an e-mail survey to all school districts in Arizona. The survey asked districts to answer the questions if they had built a new school between fiscal years 2004 and 2006. Forty-three districts responded to the survey. To answer the legislative question about the accuracy of SFB's financial information, auditors relied on information obtained in reviewing internal controls and preparing revenue and expenditure information for the Introduction and Background.

1 IT Governance Institute. *COBIT® 4.0: Control Objectives, Management Guidelines, Maturity Models.* Rolling Meadows, IL.: IT Governance Institute, 2005.

- **Introduction and Background**—To gather information for the Introduction and Background, auditors reviewed Arizona's constitution, statutes, session laws, rules, legislative committee hearings, SFB's fiscal year 2008 budget request, and the Arizona Financial Information System (AFIS) *Accounting Event Transaction File and Revenue, Expenditures by Fund, Program, Organization, and Object,* and *Trial Balance by Fund* reports for fiscal years 2005 and 2006.

This audit was conducted in accordance with government auditing standards.

The Auditor General and staff express appreciation to the board members, Executive Director, and staff of the School Facilities Board for their cooperation and assistance throughout the audit.

FINDING 1

Future new school construction costs will place increasing demands on General Fund

Several factors are converging that will place increasing demands on the New School Facilities program and on the General Fund, which is quickly becoming the program's sole source of support. Rising construction costs and rising student enrollment are projected to create a need for new school construction expenditures totaling $2 billion to $2.4 billion between fiscal years 2008 and 2012. Under the current funding mechanism, all of this amount will have to come from the General Fund because other sources of revenue used in previous years will be exhausted by fiscal year 2008. Further, recent interpretations of minimum adequacy guidelines will potentially increase the impact on the General Fund. SFB should seek a formal Attorney General opinion to clarify its authority to make additional awards to pay for design elements not previously spelled out in the guidelines.

Program provides General Fund monies to build new schools

The New School Facilities program provides K-12 school districts monies to purchase land and construct new school facilities to accommodate student enrollment growth. SFB is required to provide monies when needed pursuant to A.R.S. §15-2041. A district is eligible for funding if SFB-approved projections indicate that additional space will be needed within the next 2 years for an elementary school or within the next 3 years for a middle or high school.

According to a December 2006 report by the Texas Legislative Council, Arizona is 1 of 8 states that use a stand-alone agency to administer school facility funding.[1] The Texas Legislative Council found that 35 states administer school facilities funding within their state departments of education, including nearly all of the states that provide facilities funding as basic aid, debt service aid, and state loans.

Arizona is 1 of 8 states that use a stand-alone agency to administer school facility funding.

1 Texas Legislative Council. *Facts at a Glance*: *State Roles in Financing Public School Facilities*. Austin, TX: Texas Legislative Council, December 2006.

Seven states use a different state agency or a combination of agencies to administer their school facilities programs. For example, Maryland's Board of Public Works, which approves all state capital projects, also administers the Public School Construction Program. Generally, according to the Texas report, programs operated by departments of education have fewer staff and provide less oversight than programs administered by a separate agency for facilities funding.

According to the 2006 Texas report, 46 states had programs to provide school facilities funding. Thirteen states—Arizona, Arkansas, Colorado, Kansas, Kentucky, Louisiana, Maine, Montana, New Hampshire, New York, Pennsylvania, Rhode Island, and Texas—used general fund monies as the primary source of state funding for new school construction. Nineteen states were currently using general obligation or general revenue bond proceeds at the time of the 2006 Texas report, either alone or in conjunction with other sources of funding. Several states designated specific revenues to provide monies for school facilities. For example, 6 states used dedicated or appropriated lottery proceeds to provide school funding, while 3 states used dedicated sales tax revenue. According to the report, 14 states were using or proposing to use a different revenue source, such as cigarette tax proceeds, a state wagering tax, or criminal fines and unclaimed property. Only 4 states had no role in helping local school districts pay for public school facilities.

General Fund demands expected to increase

Arizona's choice to fund new school construction from the General Fund makes it particularly important for the Legislature to be aware of projected future new school facilities construction costs. Construction inflation has affected the funding needs for new school facilities and is expected to keep rising. In addition, Arizona's student population has risen substantially in recent years and is expected to continue to grow well into the future. As a result, new school construction cost projections call for increased amounts of funding that will raise annual expenditures for new school construction from about $351 million in fiscal year 2006 to an estimated $450 million to $544 million in fiscal year 2012.

JLBC-Adopted Indices

Fiscal Year	Index Amount
2000	3.1%
2001	5.0%
2002	0.6%
2003	0.0%[1]
2004	4.2%
2005	1.4%
2006	12.85%
2007	12.20%

1 JLBC did not adopt an inflation adjustment in fiscal year 2003. In fiscal year 2004, JLBC adopted a combined adjustment for fiscal years 2003 and 2004.

Source: Auditor General staff summary of JLBC-adopted indices.

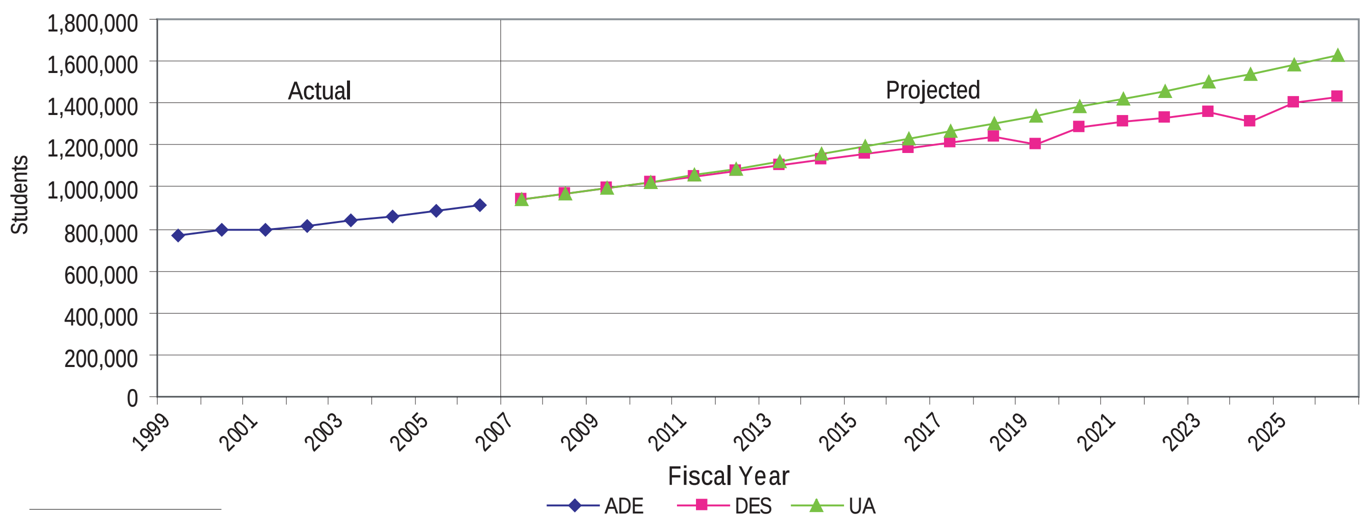
Construction costs rising—Construction inflation has already had a substantial effect on costs, particularly in fiscal years 2006 and 2007. To address inflationary needs for new school construction, statute requires the Joint Legislative Budget Committee (JLBC) to at least annually develop or identify an index to adjust for construction market conditions. JLBC has prepared these adjustments, and between fiscal years 2000 and 2005, the adopted increases ranged from zero to 5 percent, with increases above 12 percent in fiscal years 2006 and 2007 (see textbox). In a February 2007 letter, SFB asked JLBC to consider another 3 percent increase. At the discretion of the JLBC Chairman, this request was not included in the agenda for the March 29, 2007, JLBC meeting.

According to a September 2006 report from the Associated General Contractors of America, the excess of construction costs over general inflation will likely persist for the foreseeable future.[1] According to a 2005 survey of 167 public owners involved in construction projects throughout the United States, the average price increase in 2005 was 13.2 percent.[2] An October 2006 presentation to the Joint Legislative Budget Committee by JLBC staff reported that in 2006, indices for construction inflation in Phoenix were from 5.9 percent for all structures built with masonry bearing walls to 13.1 percent for a 70,000-square-foot elementary school.[3] Construction industry inflation is linked to demands and price increases for materials such as steel, concrete, gas, and petroleum products, such as asphalt.

Student enrollment continues to grow—Arizona's K-12 student population grew by almost 19 percent between fiscal years 1999 and 2006, and SFB projections call for an increase of another 27 percent by 2015. As shown in Figure 3, the number of students enrolled in Arizona district schools, excluding charter

Arizona's K-12 student population grew by almost 19 percent between fiscal years 1999 and 2006.

Figure 3: Actual and Projected Student Growth[1]
Fiscal Years 1999 through 2026



1 Actual student growth is based on districts' 100th-day Average Daily Membership (ADM) that they report to the Arizona Department of Education (ADE). Student growth projections are prepared by SFB staff based on projected ADM calculated from Arizona Department of Economic Security (DES) and University of Arizona (UA) population projections.

Source: Auditor General staff analysis of *Annual Report of the Superintendent of Public Instruction Volume I Fiscal Year 2005-2006* and SFB staff analysis of DES and UA population projections.

1 Simonson, Ken. *AGC Construction Inflation Alert: The Continuing Sticker Shock.* Arlington, VA: The Association of General Contractors of America, September 2006.

2 PinnacleOne. *The 2005 PinnacleOne Pulse of the U.S. Public Construction*. Tempe, AZ: PinnacleOne, 2005.

3 JLBC staff presented four different indices. The lowest index, 5.9 percent, was the Marshall Valuation Service (MVS) construction cost index for class C structures (masonry-bearing walls) for Phoenix. According to the presentation, schools are typically class C structures. The highest index, 13.1 percent, was developed by PinnacleOne, a project management firm, based on the cost of a 70,000-square-foot K-6 school in Phoenix. The other two indices were a nation-wide Bureau of Economic Analysis index for state and local government investments-structures (7.9 percent) and an index for all types of Phoenix-area construction, developed by international construction-consulting firm Rider, Hunt, Levett, & Bailey (11.27 percent).

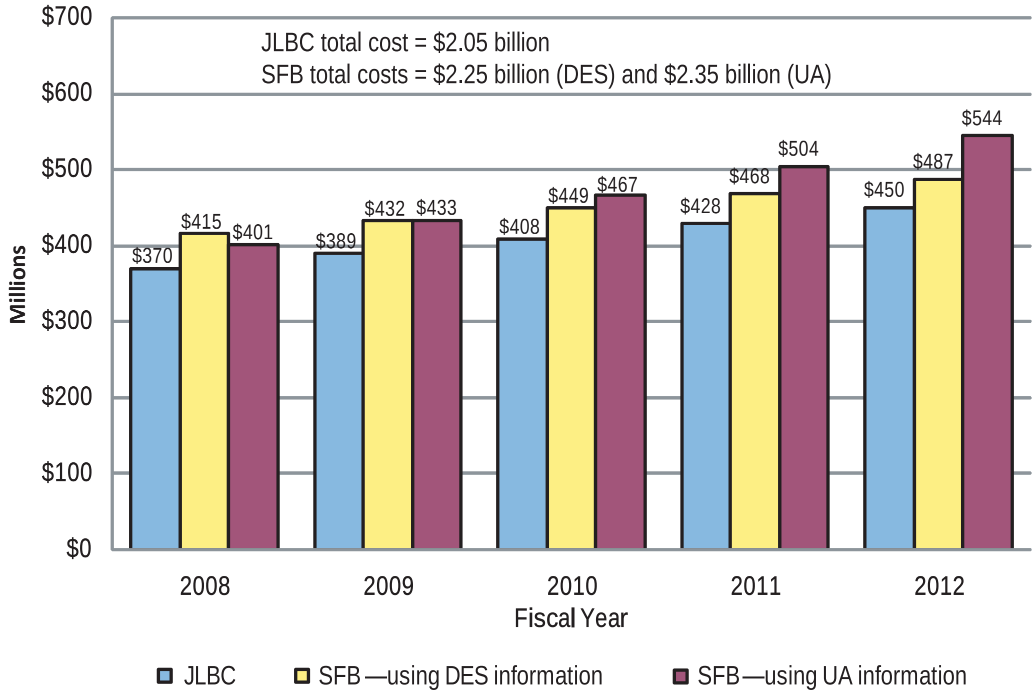
schools, increased from approximately 800,000 in fiscal year 2001 to more than 900,000 in fiscal year 2006, and because of continued increases expected in the State's overall population, SFB projects that the number of students will grow to more than 1.2 million by 2017. These projections rely on population projections produced by the Arizona Department of Economic Security (DES), which projects that Arizona's population, which was approximately 6.4 million in 2007, will grow to 7.9 million by 2015. Similarly, the U.S. Census Bureau and the University of Arizona also project continued growth in the State's population, to 7.4 million by July 1, 2015, according to the U.S. Census Bureau, and to 8.4 million by 2016, according to the University of Arizona. According to the U.S. Census Bureau, Arizona was the fastest-growing state in the nation between July 1, 2005 and July 1, 2006.

Combination of factors expected to increase new school construction funding demands in future—Because of student enrollment growth and rising costs of construction materials, increased new school construction funding demands can be expected. For fiscal year 2007, SFB staff estimated that SFB will spend approximately $350.6 million for new school construction projects. Using different estimating approaches, JLBC and SFB staff projected fiscal year 2012 costs of $450 million (JLBC) and either $487 million or $544 million (SFB staff) depending on the population growth estimates used. Between fiscal year 2008 and fiscal year 2012, JLBC projected that the total cost for new school construction will be $2.05 billion, while SFB staff projected either $2.25 billion or $2.35 billion in costs for the same period. Figure 4 (see page 19) shows the year-by-year projections, which are based on the following methodologies:

- JLBC used 10-year averages to estimate future student enrollment growth and inflation. Specifically, JLBC used U.S. Census Bureau figures for fiscal years 1997 through 2002 and Arizona Blue Chip figures for fiscal years 2003 to 2006 and calculated that Arizona's population had grown by 3 percent per year, on average, during the 10-year period. JLBC used the Gross Domestic Product (GDP) deflator compiled by Global Insight for fiscal years 1997 through 2006 and calculated that average inflation was 2 percent per year during the 10-year period. JLBC then combined the two averages to obtain a total increase of 5 percent, and applied that rate each year to determine future costs. Using these estimates, JLBC calculated that the cost for cash financing of new school construction will increase to approximately $450 million for fiscal year 2012.

- SFB staff prepared two projections, using two different population growth estimates. First, using an estimated annual growth rate ranging from 2.57 to 2.97 percent based on information from DES, SFB staff projected that the number of students will grow by 137,436 between 2008 and 2012. Using an estimated annual inflation rate of 4.92 percent based on an average of the JLBC-adopted inflation increases for fiscal years 2000 through 2007, SFB staff estimated the cost for new school construction for fiscal year 2012 will be approximately $487 million if DES population estimates are correct. Second, using an estimated student growth rate of

Figure 4: Comparison of JLBC- and SFB-Projected Costs for New School Construction Fiscal Years 2008 through 2012



Source: Auditor General staff analysis of cost projections based upon population projections prepared by JLBC and SFB.

2.87 percent based on information from the University of Arizona's Eller College of Management (UA), SFB staff projected a need for approximately 14.2 million square feet of new school space between fiscal years 2008 and 2012. Using the same estimated inflation rate of 4.92 percent, SFB staff estimated the cost for new school construction for fiscal year 2012 will be approximately $544 million if UA population estimates are correct.

SFB staff projected a need for approximately 14.2 million square feet of new school space between fiscal years 2008 and 2012.

Further, nearly the full amount of these projected costs will need to be funded from new appropriations to the New School Facilities Fund, under the current funding mechanism. In prior years SFB has had a positive balance in its New School Facilities Fund, and received approximately $900 million in revenues from lease-to-own agreements entered into during fiscal years 2003 through 2006. However, by the end of fiscal year 2008, SFB staff estimate that all of these lease-to-own revenues will have been spent and the New School Facilities Fund's fund balance will also be gone.[1] In fiscal year 2008, SFB estimated that it will receive $5 million in rental income, but all of its other revenues for this Fund will come from appropriations.

1 The Legislature could authorize use of lease-to-own agreements in the future. However, Laws 2006, Ch. 353, §29 states that it is the Legislature's intent that as a consequence of appropriating $250 million to the New School Facilities Fund in fiscal year 2007, it does not intend to appropriate any future amounts to make payments for any lease-to-own transactions entered into in fiscal year 2007.

Recent SFB interpretations may result in greater General Fund impact

SFB interpretations of minimum adequacy guidelines, which are used to determine awards in excess of the statutory funding formula amount, will potentially increase the impact on the General Fund under the current funding mechanism. Statute establishes the amount per square foot that SFB must provide to accommodate enrollment growth, but it also allows SFB to distribute money in excess of the statutory amount to accommodate inflation based on an index identified by JLBC and other specified factors. SFB has made such additional awards beyond the statutory amount, which totaled $31.8 million in fiscal year 2007. Although SFB management explained that the awards were necessary to compensate for inflation and allow districts to build schools comparable to those built in previous years using the statutory formula amount, the additional awards may exceed SFB's statutory authority because they were not based on the factors specified in statute. To determine if distributing these additional monies is within the scope of its authority, SFB should seek a formal Attorney General opinion and then follow the Attorney General's advice.

SFB can distribute monies in excess of statutory formula amount—As required by A.R.S. §15-2041, SFB staff calculate new construction award amounts based on the number of students, the required minimum square feet per student, and a cost per square foot. The statute specifies four factors that may increase the cost per square foot amount: (1) an annual adjustment for market conditions based on an index identified by JLBC, (2) a 5 percent adjustment for schools located in rural areas, (3) geographic conditions, and (4) site conditions.

SFB makes additional awards to districts—If a district believes it cannot build a school using the calculated amount, SFB allows it to request additional monies. As part of its application to SFB, the district must prove it cannot build a school that meets the minimum adequacy guidelines with the formula amount. During fiscal years 2006 and 2007, SFB awarded additional monies for 10 out of 26 and 23 out of 27 new construction projects, respectively. The additional awards totaled $20.4 million in fiscal year 2006 (an increase of approximately 7 percent over the statutory formula total of $292.3 million) and $31.8 million in fiscal year 2007 (an increase of approximately 11 percent over the formula total of $279.9 million).

To guide staff in determining what SFB will pay for, it has issued interpretations of minimum adequacy guidelines. Some of these interpretations are intended to reduce costs, such as a requirement that specifies the maximum number of buildings on a school campus that SFB will pay for. A campus with more buildings has greater costs because of utility, sidewalk, and other connections between buildings and the need to duplicate certain infrastructure components in each building. Other interpretations are meant to allow districts to include design elements commonly included in schools built in previous years. For example, although minimum adequacy guidelines do not require playgrounds in K-6 schools, SFB staff reported that districts included them in their schools and paid for them using formula monies before rising costs reduced what the formula amounts would cover. SFB staff reported that other factors have also reduced what districts can build with formula monies. For example, SFB staff reported that some local governments have increased permit fees and stopped providing fire lanes, driveways, and sidewalks adjacent to schools, forcing districts to pay for them as part of school construction. In its February 2007 meeting, the Board voted to provide monies for playgrounds and other design elements not previously spelled out in minimum adequacy guidelines, as shown in Table 3. SFB staff estimated that these interpretations will add $7.12 per square foot to the total cost of building a new school.

Table 3: SFB New Interpretations to Minimum Adequacy Guidelines[1]

Item	(N)ew or (R)evised Standard	Suggested Application	Total Estimated Cost[2]	Estimated Cost per Square Foot
Flooring	R	Flooring (carpet or vinyl composition tile) throughout the school, and tile floors in bathrooms	$ 96,000	$1.20
Gym floors	R	One 8,400 square-foot floor	109,000	1.36
Millwork	R	10 linear feet per classroom	76,000	0.95
Exterior lighting	N	Exterior lights every 50 feet and parking lot lights	36,200	0.45
Canopies	N	Exterior canopy square footage equal to 1 percent of interior square footage	16,000	0.20
Playground structures	N	Two playground structures with canopies for each K-6 campus	130,000	1.63
Landscaping	N	1 percent of total budget allowed for landscaping	106,280	1.33
Total			$569,480	$7.12

1 Applied to new schools built after February 1, 2007.

2 Based upon an average 80,000 square-foot school.

Source: Auditor General staff analysis of SFB board meeting packet for the February 1, 2007, board meeting and information provided by SFB in April 2007.

SFB distributions may exceed statutory authority—In making its awards of additional monies to districts, SFB relies on a 2004 Attorney General opinion that answered two questions about adjusting awards after a project was approved. In the opinion, the Attorney General concluded that SFB could adjust the approved base cost for good cause. Specifically, the opinion said SFB may award an inflationary increase for good cause, for example if project delays justify the change. Relying on the statute, the opinion defined the inflationary increase as the annual adjustment for market conditions based on an index identified or developed by JLBC.

Although SFB's Attorney General representative refers to the additional awards as inflationary increases, the additional awards are not based on the annual JLBC adjustment. Instead, they are calculated to pay for design features that, according to SFB staff, were commonly included in schools built in previous years. Adding monies to pay for design features not included in the minimum adequacy guidelines, such as playgrounds, in order to compensate for rising costs, appears to go beyond the Attorney General's 2004 opinion.

To ensure its awards of monies in excess of the statutory formula amount are within the scope of its authority, SFB should seek a formal opinion from the Attorney General to determine whether it has the statutory authority to award additional monies to pay for specific design features based on SFB's interpretation of the minimum adequacy guidelines. Once the opinion is received, SFB should comply with the opinion based on its interpretation of the minimum adequacy guidelines.

Recommendations:

1. To ensure its awards of monies to school districts in excess of the statutory funding formula amount are within the scope of its statutory authority, SFB should seek a formal opinion from the Attorney General to determine whether it has statutory authority to award additional monies to pay for specific design features.

2. Once the opinion is received, SFB should comply with the opinion.

FINDING 2

Building renewal formula may need modification

The Legislature should consider modifying the school district building renewal funding formula. The Legislature has not used the formula to determine funding levels in recent years and has several times passed bills with changes designed to make the formula more workable. The Governor has vetoed these changes, citing concerns from a pending lawsuit, which is awaiting a final court order. In June 2007, the Legislature established a task force to review and make potential recommendations to change the building renewal formula. Modifying and using the formula would help make funding more predictable for school districts. In the past, modifications studied and proposed included changing how older buildings and portables are treated, using replacement costs instead of new construction costs, and revising the assumptions for determining square footage.

Statute contains funding formula

A.R.S. §15-2031 requires SFB to use a statutorily prescribed funding formula to determine districts' annual building renewal amounts and to distribute the monies after an annual review of the distributions by the Joint Committee on Capital Review. The statutorily prescribed formula (see textbox, page 24) is based on a formula created by two facilities management experts, Douglas Sherman and William Dergis, to quantify the total amount of money needed for building renewal for a group of buildings in a particular year. The formula is not a technique to determine how much money needs to be spent on any one building in any one year, but considers that all of the dollars calculated by the formula are pooled in a fund to support major renewal projects. Under the formula, the available monies in a given year can be used to completely renew one building or to partially renew several buildings.

A.R.S. §15-2031 requires SFB to use a statutorily prescribed funding formula to determine districts' annual building renewal money distributions.

Building renewal—A budgeting mechanism used by a state to attempt to preserve its buildings. It involves repairing or reworking of a building that will result in maintaining or extending its useful life.

The Sherman-Dergis formula is well known and is used by other Arizona agencies. The Arizona Department of Administration (ADOA), the Board of Regents (ABOR), and the Department of Transportation (ADOT) use it to determine annual building renewal allocations for their

Arizona building renewal formula

The components of the formula are:

1. Building square footage
2. Building age
3. New construction cost per square foot

Source: Auditor General staff analysis of A.R.S. §15-2031.

state-owned or occupied buildings and to make recommendations to the Legislature on their annual building renewal appropriations. As of August 29, 2006, this formula was used to determine the annual funding for 5,365 ADOA, ADOT, and ABOR building structures in Arizona. In 2000, the Legislature established a Joint Legislative Study Committee that included representatives from the three agencies to study this formula to determine its adequacy and the building renewal system process to determine its effectiveness. The Committee found that the formula provides adequate support for state building renewal needs and the State should adequately fund building renewal in order to avoid long-term costs of deferred maintenance. However, the study did not examine building renewal for school districts.

Legislature has used various mechanisms to determine funding

The Legislature has generally not funded the Building Renewal Fund at the level the formula indicates it should be.

The Legislature has generally not funded the Building Renewal Fund at the level calculated by the formula. Instead, the Legislature has used various other mechanisms to determine annual appropriations for the school district building renewal program.

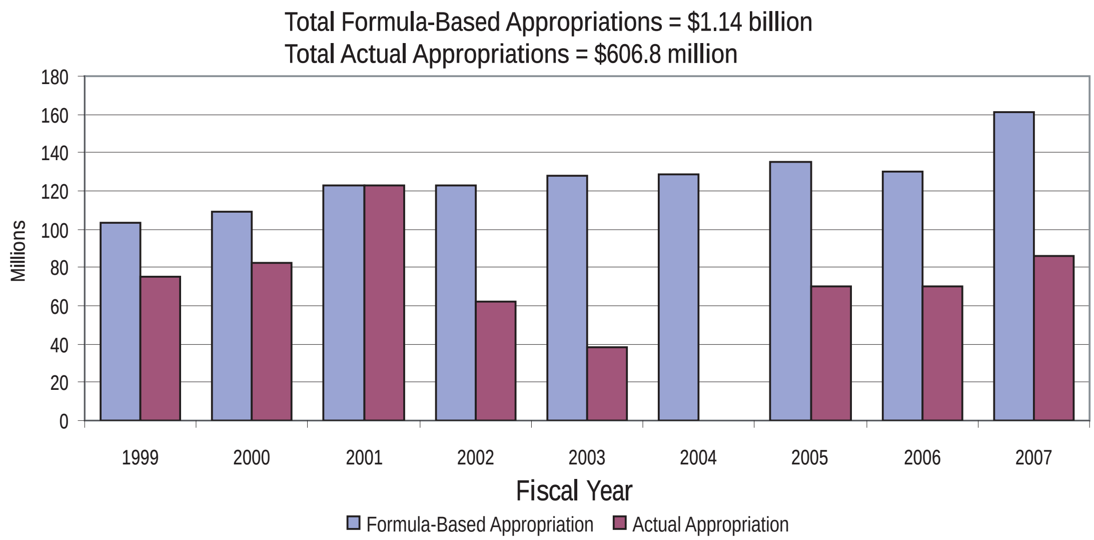
The school district building renewal funding history for fiscal years 1999 through 2007

1999—Funding based on Students FIRST legislation
2000—Funding reflects 10 percent increase from previous year
2001—Full funding based on the statutory building renewal formula
2002—Partial funding based on the building renewal formula
2003—Partial funding based on the building renewal formula
2004—No funding
2005—Full funding of a revised, lower formula
2006—Full funding of a revised, lower formula
2007—Full funding of a revised, lower formula

As illustrated by the textbox, the Legislature funded this program as prescribed in statute in fiscal year 2001 but provided different amounts in other years. For example, it provided a portion of the formula amount in fiscal years 2002 and 2003 and used a different formula for fiscal years 2005, 2006, and 2007.

As shown in Figure 5 (see page 25), under these various approaches, actual appropriations totaled $606.8 million during fiscal years 1999 through 2007, compared with funding of $1.14 billion that would have been provided if the building renewal program had been funded to the formula. SFB distributes building renewal monies to each district based upon the amount the Legislature appropriates each year. Excluding fiscal years 2001 (when funding was provided using the statutory formula) and 2004 (when no funding was provided), these distributions have ranged from 30 to 76 percent of the amount districts would have received if the Legislature had fully funded the program based on the funding formula.

Figure 5: Comparison of Formula-Based and Actual Appropriations of Building Renewal Monies Fiscal Years 1999 through 2007[1] (Unaudited)



1 Fiscal years 2003 and 2004 amounts for the formula-based appropriation were received from SFB.

Source: Auditor General staff analysis of JLBC appropriations reports for fiscal years 1999 through 2007.

Attempts to change formula were vetoed; litigation prompting vetoes awaits final court order

The Legislature passed bills that would have changed the formula, but each time the Governor vetoed these bills, citing pending lawsuits.

There have been several proposals for modifying the building renewal formula in the past. In the 2003, 2004, 2005, and 2006 legislative sessions, the Legislature passed bills that would have changed the formula, but each time the Governor vetoed these bills, citing pending lawsuits. Specifically, in 1999 and 2001, eight districts filed lawsuits to force the Legislature to fully fund the building renewal formula under Students FIRST. The Governor's vetoes were based on a concern that altering the formula could adversely impact the State's ability to defend or favorably settle the litigation.

The litigation that prompted the Governor's veto is awaiting the final order of the Superior Court. The Court combined the eight districts' lawsuits into a single case. In October 2006, the Court found in favor of the State, granting summary judgment because all the districts had not exhausted all available sources of funding to

K-12 School Facilities Task Force Members

- Five Senate members
- Five House members
- One school district teacher
- Two members from the business community
- One private citizen representing a taxpayer organization
- One member with expertise in urban school district facilities management
- One member with expertise in rural school district facilities management
- One member with public finance knowledge and experience
- One member with school finance knowledge and experience in a public school system
- One member with housing development knowledge and experience
- SFB's Executive Director or his designee, serving as an advisory nonvoting member

Source: Laws 2007, Chapter 266, §4.

address their needs, such as the Emergency Deficiencies Correction Fund monies. (See Other Pertinent Information, pages 51 through 53, for more information on the Emergency Deficiencies program.) Further, in June 2007, the State requested the Court to dismiss the case because districts could not yet prove their claim. The State is awaiting a final court order.

The Legislature has already established a task force that will study the building renewal formula. In June 2007, the Governor signed HB2792, which establishes a task force consisting of 20 members (see textbox). The K-12 School Facilities Task Force's duties include reviewing and recommending potential changes to the building renewal formula. An initial report must be submitted by December 1, 2007, and a final report summarizing findings and recommendations is due by December 1, 2008, to the Governor, the President of the Senate, and the Speaker of the House of Representatives.

Revising formula could make funding more predictable for districts

Modifying the formula could make funding more predictable and help districts better manage the use of their building renewal monies.

A revised formula could help school districts better manage their monies by making future funding more predictable. As of June 30, 2005, several districts held significant balances of building renewal funds, in part because they were saving for major renovations, but also because they did not know how much funding they would receive in subsequent years. Modifying the formula could make funding more predictable and help districts better manage the use of their building renewal monies.

Some districts accumulated large balances—Past efforts to change the formula arose, in part, because the formula appeared to provide too much money since it allowed many districts to accumulate large fund balances. As illustrated in Table 4 (see page 27), districts' ending fund balances totaled approximately $89.6 million for fiscal year 2005 and decreased to approximately $83.8 million for fiscal year 2006. Six of these districts held approximately 35 to 37 percent of the overall Building Renewal Fund balance for fiscal years 2005 and 2006, respectively.

Because districts cannot predict building renewal funding awards, it is difficult to manage their building renewal projects. Auditors interviewed officials in seven districts to learn how funding fluctuations had affected their ability to manage building renewal projects and to find out why the districts had accumulated large

Table 4: Comparison of Number of Districts and Unexpended End of Year Building Renewal Fund Balances[1]
Fiscal Years 2005 and 2006
(Unaudited)

	2005		2006	
Range of Ending Fund Balances	Number of Districts	Total Fund Balances (In Millions)	Number of Districts	Total Fund Balances (In Millions)
($150,001)–($1)	4	($ 0.22)	4	($ 0.05)
$0	1	0.00	0	0.00
$1—$50,000	63	1.10	58	1.02
$50,001—$100,000	31	2.29	29	2.01
$100,001—$250,000	41	6.55	48	8.21
$250,001—$500,000	33	12.07	33	11.20
$500,001—$1,000,000	18	12.58	19	12.73
$1,000,001—$3,000,000	12	21.96	11	19.86
$3,000,001—$8,000,000	6	33.28	6	28.80
Total		$89.61		$83.78

1 In addition, as of June 30, 2006, SFB held approximately $11.6 million of building renewal monies for districts that did not comply with statutorily established reporting requirements.

Source: Auditor General staff analysis of the Annual Financial Reports for fiscal years 2005 and 2006 submitted by districts to the Arizona Department of Education.

fund balances. According to district officials, not receiving the full building renewal funding amount in the past several years has had several effects. Specifically:

- **Repairs delayed**—Officials in five out of seven districts reported that they had delayed building renewal projects because they had not received the projected amount of money. For example, according to one district official, the district delayed some renovation and repair projects until it could obtain bond proceeds because the district did not have enough building renewal monies to address all of its needs. Specifically, the district proposed using bond proceeds to pay for needed renovations and repairs totaling $79 million, including replacing portable buildings that are about 40 years old and had rotten flooring, which allow animals to get into the structure. Other proposed projects included roofing repairs, sewer line replacement, and renovating a bathroom that was closed because of mold. This large district had received $6.6 million in building renewal monies in fiscal year 2006 and had a year-end Building Renewal Fund fund balance of $4.5 million. However, the district had already committed approximately $4.5 million of the ending fund balance for other building renewal needs and had only $8,996.55 available as of June 30, 2006.

- **Fund balances used to save for large projects and to compensate for fluctuations**—Officials in three out of seven districts explained that they must carry forward building renewal monies to pay for major renovations in a future year. For example, one large urban district that had a $5.9 million Building

Renewal Fund ending fund balance as of fiscal year 2006 intended to spend $10 million in fiscal year 2007 and $6.5 million in fiscal year 2008, including bond proceeds, to complete building renewal projects including roofing renovation and retrofitting. This is consistent with the intent of the building renewal formula, which is not meant to determine how much money needs to be spent on any one building in any one year, but to allow for pooling monies to support major renewal projects.

Further, officials in two out of the seven districts explained that because building renewal funding has greatly fluctuated from year to year, they maintain a fund balance for unexpected needs. For example, one official reported that one year the district used some of its Building Renewal Fund fund balance to pay for unexpected roofing and flooding damage caused by heavy monsoon rains.

Although some of the proposed repair and renovation projects funded with bond monies may not be eligible for building renewal monies, they illustrate the districts' overall repair and renovation needs.

- **Districts use bonds to pay for some repairs and renovations**—Officials in four out of seven districts reported that despite having Building Renewal Fund fund balances, these balances often represent only a fraction of their repair and renovation needs. Although some of the proposed repair and renovation projects paid for with bond monies may not be eligible for building renewal monies, they illustrate the districts' overall repair and renovation needs. In fact, these districts have issued bonds far in excess of their Building Renewal Fund fund balances to meet these needs. For example, a large district that had a fiscal year 2006 year-end Building Renewal Fund fund balance of $5.1 million planned to use approximately $183 million in bond proceeds to renovate science classrooms and libraries, and to provide drainage, waterproofing, and roof repairs. The district had received $300,000 in building renewal monies in fiscal year 2006. Another district that had a fiscal year 2006 year-end Building Renewal Fund fund balance of $400,000 hired a consultant to assess its needs. The consultant estimated that the district needed approximately $110 million to address its needs, including returning buildings, grounds, buses, and classrooms to an acceptable standard. The district prioritized the projects and revised this estimate to $65 million. The district requested a bond authorization of $53.1 million in November 2006 and plans to use approximately $35.5 million in bond proceeds for building renovation and repair. The district had received $1.4 million in building renewal monies in fiscal year 2006.

Revised formula could allow districts to better manage their building renewal monies—The Legislature could help districts better manage the use of their building renewal monies by establishing a funding mechanism that would allow districts to predict funding. A.R.S. §15-2031(F) requires districts to prepare a 3-year plan that details how they will use building renewal monies. However, SFB knows only how much money districts will receive the first year of the 3-year plan.

Therefore, it requires districts to prepare and submit plans based on the funding formula amount for years two and three. However, since funding does not always equal the amounts in the plan, districts are not always able to follow the submitted plans.

Districts are not always able to follow the submitted plans since funding does not always equal the amounts in the plan.

Previously proposed changes addressed various aspects of formula

The Legislature should consider modifying the school district building renewal funding formula. Proposed formula modifications that have been advanced, both as JLBC recommendations and as part of past legislation, included changing how older buildings and portable buildings are treated, using replacement cost instead of new construction cost, and revising the assumptions for the costs per square feet. To provide additional perspective that the Legislature may wish to consider in reviewing the formula, auditors contacted William Dergis, one of the creators of the building renewal formula, and asked for his views regarding potential changes in these areas. The changes recommended by JLBC, together with Mr. Dergis' comments on those proposed changes, follow:

Proposed formula modifications have been advanced, both as JLBC recommendations and as part of past legislation.

- **Limiting the building age to 30 years**—The formula considers the life of each building to be 50 years. Based on the formula, an older building's need for building renewal funding is projected to increase every year up to 50 years. In its fiscal year 2005 budget recommendations, JLBC recommended reducing the building life to 30 years, meaning that older buildings' funding needs would be considered the same as those of a 30-year-old building. Mr. Dergis stated that the lifespan of buildings is generally 50 years, which is commonly accepted in the industry. He did not recommend reducing the building life to 30 years.

- **Treating portable buildings the same as permanent buildings**—The formula provides six times as much money for portable buildings as for permanent buildings to recognize the shorter lifespan of portable buildings. JLBC recommended treating portable buildings like permanent buildings because although portable buildings have a shorter life than permanent buildings, the life of portable building systems is about the same as a permanent building system. However, Mr. Dergis stated that there should be a premium for portable buildings because these buildings have a lower original unit cost and they are usually not built to last as long as they are used. Therefore, they often incur more renewal work during their lifetime than would a permanent building of the same size. He did not specify how portable buildings should be treated but recommended using local data to determine an adequate multiplier.

- **Using the replacement cost to develop the replacement value of the building**—The formula uses the new school construction cost, which includes the cost of furniture, equipment, and unexpected construction costs. JLBC recommended using the replacement cost, which excludes equipment, furniture, and other contingencies, when computing building renewal needs. Mr. Dergis explained that the replacement cost should represent the size and the complexity of a building. Complexity refers to the type of facilities within a building, such as science laboratories. However, he recommended that items like furniture and moveable equipment should not be considered as part of the replacement cost.

- **Making the per-student square footage in accordance with minimum adequacy guidelines**—The formula uses a per-student square footage that is higher than either actual square footage or minimum square footage based on the minimum adequacy guidelines. The additional square footage is included to allow for student growth. However, JLBC recommended using the minimum square footage standard instead. Mr. Dergis said he did not have enough information to comment on this change.

Recommendation:

1. The Legislature should consider modifying the school district building renewal funding formula to help districts better manage their building renewal monies.

FINDING 3

SFB should improve oversight of districts' use of building renewal monies

SFB should improve its oversight and reporting of Building Renewal Fund expenditures. As prescribed by statute, Building Renewal Fund monies are restricted for specific purposes. SFB is responsible for administering and distributing monies from the Building Renewal Fund; however, it does not have a process in place to review districts' annual building renewal expenditures reports. Some districts have used building renewal funds inappropriately, such as to replace playground structures and to purchase stage curtains and a projector screen. SFB should establish and implement policies and procedures for reviewing districts' building renewal expenditure reports and taking appropriate action.

Building renewal monies restricted to specific purposes

SFB administers the Building Renewal Fund for the purpose of maintaining the adequacy of existing school facilities, including academic space and other buildings owned by school districts. These monies may only be used to pay for items or services that will help maintain or extend the useful life of buildings (see textbox). For instance, a district can use these funds for the replacement or repair of a roof, but cannot use them to pay for exterior beautification, such as landscaping.

Approved and prohibited uses of Building Renewal Fund monies

Approved uses:

- Building renovations and major repairs
- Upgrades to maintain or extend a building's useful life
- Infrastructure costs
- Portable or modular building placement or relocation

Prohibited uses:

- New construction
- Aesthetic or preferential remodeling of interior space
- Exterior beautification
- Demolition
- Purchase of soft capital items such as textbooks
- Most routine maintenance, except:
  - Districts may use up to 8 percent of their building renewal allocations for preventive maintenance
  - Schools may use building renewal monies to bring inadequately maintained buildings into compliance with district routine maintenance guidelines.

Source: Auditor General staff summary of A.R.S. §15-2031 and SFB's *Building Renewal Policy*.

SFB staff provide limited oversight

Statute requires districts to submit building renewal plans and reports showing how they used building renewal monies.

Although SFB staff review school districts' building renewal plans, they could provide better oversight of districts' building renewal expenditure reports. To comply with reporting requirements, districts must submit two reports to SFB every year. Specifically, statute requires districts to submit building renewal plans and report building renewal projects funded in the prior year and remaining fund balances. Districts cannot receive building renewal monies if they do not submit the required reports. These reports help to educate districts on the appropriate uses of building renewal monies and can be used to determine if districts used monies as allowed by statute.

SFB staff review how districts plan to use building renewal monies—A.R.S. §15-2031(F) requires that by October 15 of each year, each district must submit a 3-year plan to SFB showing how it will use building renewal monies. The plan must include a list of projects and their expected costs for each school in the district. SFB staff with construction knowledge, called liaisons, review the plans to determine if the projects meet statutory requirements for building renewal monies and if the estimated costs appear to be reasonable. If a district's plan includes inappropriate planned expenditures, the district must revise and resubmit it. The liaisons assist districts in revising their plans and in the process they educate districts on appropriate uses of these monies. Each district's building renewal plan must be approved by the Board before a district can receive building renewal monies for the following year. To help districts comply with the requirement to submit their plans, SFB introduced a Web-based program for the submittal of these reports in September 2006.

SFB staff provide limited oversight of actual expenditures—Under the same statute, by October 15 of each year, each district must also submit to SFB an annual report showing how it used building renewal monies in the previous fiscal year. To comply with this requirement, districts must submit building renewal expenditure reports detailing a list of projects paid for with building renewal monies, the actual costs of the projects, and total building renewal expenditures. Before this audit began, SFB staff collected the reports and used them to compile an annual report required by A.R.S. §15-2002 that shows each district's Building Renewal Fund's beginning and ending fund balances and total building renewal revenues and expenditures during the year. They did not review the reports in depth. However, during the audit, SFB liaisons began to review the districts' expenditure reports to determine if districts had used monies in accordance with statute. According to SFB management, there has always been some level of review of building renewal expenditures, but they were not able to provide evidence of the review or the extent of it.

SFB staff should strengthen oversight

SFB staff need to provide greater oversight to better ensure districts spend building renewal monies appropriately. Both auditors and SFB staff identified instances of school districts inappropriately using building renewal monies. During the audit, the SFB liaisons began to evaluate expenditures for appropriateness. However, SFB staff have not yet developed a standard process for this review, and the liaisons differ in their practices. In addition, because there is no process for districts to challenge SFB's findings, SFB staff have chosen not to report inappropriate expenditures to the Superintendent of Public Instruction as required by statute.

Some building renewal expenditures inappropriate—Both auditors and SFB liaisons identified some inappropriate building renewal expenditures in a review of districts' expenditure reports. For fiscal year 2005, districts reported 2,945 building renewal expenditures totaling approximately $40.6 million to SFB. Based solely on their descriptions in the reports, 193 of the expenditures totaling approximately $4 million appeared to be potentially inappropriate uses of building renewal monies. For example, the expenditures included new construction, land improvements, and irrigation. Many of these expenditures may be appropriate. However, SFB staff can only speculate whether they are appropriate until they analyze them. In an in-depth review of 8 of the 193 expenditures, including discussing them with district and SFB officials and examining supporting documentation, auditors determined that 6 of the 8 expenditures did not meet statutory criteria for approved uses of building renewal monies. For example:

Auditors identified six expenditures that did not meet statutory criteria.

- **Playground structure replacement**—A district replaced an older playground structure totaling $88,293. The structure is not part of the building and its replacement would not expand or maintain the useful life of the facility.

- **Equipment**—A district purchased stage curtains and a projector screen for its auditorium totaling $35,063. These items are considered soft capital items and are prohibited by statute.

- **Debt repayment**—A district received a loan from a private entity in 1997, prior to SFB's establishment, to do renovations at six schools. The district used $240,165 of its building renewal monies in fiscal year 2005 to repay the loan. However, statute does not authorize building renewal monies to be used to repay debt.

Auditors also identified inappropriate building renewal expenditures in a review of expenditures reported in the districts' Annual Financial Reports (AFR) to the Arizona Department of Education. In fiscal year 2005, districts' AFRs reported building renewal expenditures totaling approximately $44.2 million. Based on their descriptions in the reports, approximately $8.8 million of these expenditures appeared to be potentially inappropriate uses of building renewal monies. These expenditures may be appropriate, but SFB staff can only speculate whether they are appropriate until they analyze them. In an in-depth review of expenditures submitted by three districts, including discussing them with district and SFB officials and examining supporting documentation, auditors determined that some expenditures did not meet statutory criteria for approved uses of building renewal monies. For example:

- **Public address system**—A district replaced its public address system, which included a DVD player, microphones, and cart, totaling $3,031. These items are considered soft capital items and are prohibited by statute.

- **Landscaping**—A district excavated and fertilized a turf area for a total cost of $2,282. This is considered exterior beautification and is prohibited by statute.

In their review of districts' fiscal year 2006 building renewal expenditures reports, SFB liaisons found several potentially inappropriate expenditures.

SFB liaisons also found potentially inappropriate expenditures. In their review of districts' fiscal year 2006 building renewal expenditures reports, the liaisons' first review of expenditures, the liaisons found several potentially inappropriate expenditures. For example, districts reported using building renewal monies to purchase a cafeteria dishwasher, new bleachers, and a new shade cover for a playground. Districts also used the monies to redesign a bus drop-off and to install a new irrigation system and partitions in a new restroom. According to SFB officials, some of the potentially inappropriate expenditures might turn out to be appropriate after the liaisons research them further. However, the liaisons identified these expenditures as potentially inappropriate because they do not appear to maintain or extend the useful life of buildings, which is a requirement for the use of building renewal monies.

SFB should develop process for expenditure review—Although liaisons' experience, knowledge of the statutes, and relationships with the districts make them well-qualified to evaluate the appropriateness of building renewal expenditures, the lack of defined procedures results in different approaches to expenditure review among them. For example, when evaluating the appropriateness of expenditures, one liaison checked them against the district's SFB-approved plan, but the other three liaisons did not report using the approved plans as a tool during their expenditure reviews.

SFB has two possible options for conducting reviews of building renewal expenditures:

- **Review by SFB liaisons**—SFB liaisons carried out a review of fiscal year 2006 expenditures during the audit, and have the experience and expertise to conduct the review. Because the liaisons already have the knowledge and expertise, and conduct the reviews of the district's annual building renewal plans, this would likely be the most efficient approach. It would take advantage of existing expertise and would also help the liaisons carry out their ongoing responsibility to train school district personnel on appropriate uses of building renewal monies. Auditors estimated that although the review would add to each liaison's workload, the added work would total less than one full-time employee.

According to SFB officials, SFB lacks the resources to implement a comprehensive annual expenditure review. The Executive Director explained that SFB does not have the staff, expertise, or funding it would need to implement such a review. Specifically, although SFB officials agree that the liaisons are best suited to provide the necessary oversight, they believe the liaisons will face difficulties in conducting some of the required tasks such as determining if expenditures are part of a larger project or are eligible as preventive maintenance allowance. In its fiscal year 2008 budget request, the SFB asked for two additional liaisons, citing the need to conduct building renewal expenditure audits among other demands, such as increased involvement during design and construction of new school facilities. The Legislature appropriated $121,500 to hire two additional liaisons. However, according to SFB officials, the associated funding is insufficient to successfully recruit the needed liaisons.

- **Review by contractor**—As an alternative to using its own liaisons to conduct the review, SFB could contract with an auditing firm to conduct state-wide audits of building renewal expenditures. If SFB decides to contract out this review, it should consider using an auditing firm that specializes in providing construction auditing services, as it did when contracting for audits of deficiency corrections projects. Further, it should consider whether the costs of such a contract would exceed the costs of conducting the work in-house.

Whether SFB decides to conduct building renewal expenditure reviews in-house or through using a contractor, it should develop and implement a review process. This process should include researching how to identify inappropriate expenditures. Research may include contacting districts to obtain clarification on how they used these monies, obtaining documentation for the specific expenditures, and seeking guidance from SFB's Attorney General representative.

SFB should develop and implement a review process.

SFB staff have not taken action on inappropriate expenditures—SFB

has not followed a requirement in A.R.S. §15-2031 that requires that inappropriate expenditures be reported to the Superintendent of Public Instruction, who is then required to withhold other monies until the amount of inappropriate spending is made up. The Executive Director explained that SFB has never done this because it would not be fair to the districts to notify the Superintendent to withhold monies without a process for the districts to challenge SFB staff's determinations. Therefore, SFB should develop such a process. First, SFB staff should make a preliminary assessment of the expenditures and research them to identify inappropriate expenditures. Districts should then be granted the opportunity to challenge SFB staff's evaluations regarding the inappropriate expenditures if the districts believe that the expenditures are appropriate. Subsequently, SFB should make a final decision regarding appropriateness of the expenditures and report inappropriate expenditures to the Superintendent of Public Instruction. Additionally, SFB should develop and implement written policies and procedures that describe the adopted review process for assessing the appropriateness of a district's building renewal expenditures.

Recommendations:

1. SFB staff should continue their efforts to improve the oversight of building renewal expenditures by developing and implementing written policies and procedures that describe the review process for assessing the appropriateness of a district's building renewal expenditures.

2. SFB should either require its liaisons to conduct annual reviews of building renewal expenditures or contract out for such reviews. In making the decision, SFB should consider the relative costs of both options.

3. SFB should provide districts an opportunity to challenge its staffs' conclusions regarding inappropriate expenditures.

4. Once the process is in place giving districts the opportunity to challenge SFB staff's conclusions, SFB should report inappropriate expenditures to the Superintendent of Public Instruction as required by law.

FINDING 4

Controls should be improved to ensure monies paid out appropriately

SFB needs to improve its internal control framework to ensure that it appropriately manages and pays out hundreds of millions of dollars annually for school districts' projects including new school construction, deficiency correction, and emergency deficiency correction projects and for building renewal. SFB is one of the State's highest recipients of legislatively appropriated monies. Although SFB has implemented some internal controls over managing and paying for projects, it lacks a complete set of controls, resulting in a risk of paying more for school districts' projects than the projects were awarded. SFB should take steps to improve its internal control policies and procedures to help ensure payments are appropriate.

SFB manages and pays out hundreds of millions of dollars annually for school projects

SFB paid out $426 million in fiscal year 2006 for school districts' projects and building renewal.

SFB, one of the State's highest recipients of legislatively appropriated monies, pays out hundreds of millions of dollars each year for school districts' projects. Specifically, in fiscal year 2006, SFB received the State's ninth-largest appropriation and paid out more than $426 million for school districts' new construction, deficiency correction, and emergency deficiency correction projects and for building renewal. SFB staff use a project-tracking database to help calculate and keep track of payments for school districts' projects and building renewal. The database contains detailed information, including amounts and dates of SFB awards to districts, as well as payment dates, amounts, and payees. (See Finding 5, pages 43 through 50, for additional information on the project-tracking database.)

SFB risks overpaying because essential internal controls are not applied

Internal controls—processes designed to provide reasonable assurance regarding the reliability of financial information, effectiveness and efficiency of financial operations, and compliance with applicable laws and regulations.

Source: American Institute of Certified Public Accountants. *Statement on Auditing Standards No. 55.*

Although SFB has implemented some internal controls over managing and paying for school districts' building projects, a complete set of controls is lacking, resulting in a risk of paying more than the award amount for school districts' building projects. Some SFB practices have not always been followed because SFB lacks written policies and a training program. In addition, SFB lacks some important controls. As a result, some school districts have received overpayments for projects.

SFB has some good practices but they have not always been followed—SFB has developed some good practices that are conducted prior to paying school districts and vendors to help ensure that payments are appropriate. For example, SFB has established an extensive upfront process to help control and monitor the costs of building new schools. Specifically, school districts must submit enrollment projections, capital plans, and various documents throughout the process, including applications for new construction, cost estimates, and schematic designs before any monies are awarded to the districts. Additionally, districts must attend pre-bid meetings with SFB staff to discuss costs. To establish project budgets, SFB staff review documents submitted by the districts, calculate the statutory formula amount, determine any additional monies over the statutory formula that the district needs, and present the recommended project budget to SFB for approval. SFB staff use the approved budget to help monitor projects on SFB's project-tracking database in order to avoid projects going over budget. Additional controls SFB has put into place for payments to districts include requiring documentation from districts to support amounts requested and reviewing the documentation for appropriateness; obtaining signatures from a district architect and the contractor to certify the supporting documents; manually reviewing the project budget to ensure sufficient monies are available; and separating duties so that different employees prepare payments, approve payments, and enter payments on the State's accounting system.

SFB staff discovered overpayments for two projects.

However, staff did not follow SFB practices in two projects, resulting in overpayments to districts. SFB does not have written policies and procedures to ensure consistent performance of its practices or a training program to inform new staff of the practices. Consequently, SFB made overpayments soon after hiring a new business manager who was not familiar with the practices. Specifically, SFB paid two school districts a total of more than $45,000 over the approved award amount in March and May 2006. SFB staff discovered the errors during SFB's final close-out process that staff performed. SFB has recovered the overpaid monies from one school district and is attempting to recover the monies from the other.

SFB lacked evidence of one important control—According to SFB's Executive Director, SFB reconciled payments information maintained in its project-tracking database to the payments recorded in the state-wide accounting system since the software's implementation in fiscal year 2001. However, until December 2006, SFB did not retain evidence of these reconciliations. In addition, the reconciliations were conducted at a high level that may not have detected all errors. For fiscal year 2006, SFB staff reconciled the two systems for the first time. SFB staff found an unreconcilable difference of more than $200,000 in its fiscal year 2006 payments and identified changes needed in its project-tracking database to properly track expenditures and allow it to reconcile these payments in the future. Specifically, SFB created a new accounting code to record land payments and added an identifier to track payments for land.

SFB has not applied another control to all projects—SFB has a process for determining final payments that can also serve as an important control for identifying overpayments and inaccurate information, but all projects are not subject to the procedure. This close-out procedure requires school districts to submit a close-out package notifying SFB when a new construction project is complete. During the process, the Executive Director determines if the approved budget was properly recorded and if the district is eligible to receive any remaining funds. The value of this process is illustrated by its discovery of the two previously mentioned payment errors in March and May 2006 in which school districts were paid more than the award amounts.

Although the close-out process is a good control, auditors found several errors in other projects that SFB had not discovered because, although the projects were no longer active, SFB did not have a close-out package from the districts and therefore the projects had not gone through the close-out process. Specifically, by analyzing project information maintained in SFB's project-tracking database from June 1999 through November 2006, auditors identified 31 out of 530 new school construction projects where the database indicated overpayments totaling approximately $1.7 million had been made. In each of these cases, the database showed that the project had a negative balance, indicating that expenditures had exceeded awards. A review of 11 of these projects, with negative balances totaling approximately $1.5 million, found that none of them had gone through the close-out process. Auditors found several errors in the project-tracking database records for these projects, and in 10 of the 11 cases, the negative balance resulted in part from inaccurate recordkeeping. The errors included:

Auditors identified 31 out of 530 new school construction projects with expenditures exceeding awards.

- **Inaccurate awards**—SFB awards were inaccurately recorded in the project-tracker database for 9 out of 11 projects. The errors totaled $1.8 million.
- **Inaccurate payment information**—Two project payments were recorded in the wrong project account in the database.

- **Incomplete recordkeeping**—Complete project payment information was not maintained by SFB staff for 7 out of 11 projects. Altogether, 27 transactions totaling approximately $14.1 million were missing supporting documentation.

In addition to the database errors, auditors identified overpayments in 4 of the 11 projects where payments to districts exceeded SFB awards for these projects. These overpayments totaled $63,200. For example, in one of these projects, SFB had paid for an item that the district should have paid for. Specifically, SFB wrongly paid $16,740 for a share of a monthly construction payment that was the school district's responsibility.

SFB staff are asking districts to repay approximately $23,000 for two projects.

Because the projects had not gone through the close-out process, the errors had not been discovered. After auditors pointed out the errors, SFB staff reviewed all 31 projects and are now taking appropriate action. In some cases, SFB is taking more than one type of action. Specifically, SFB is asking districts to repay approximately $23,000 for 2 projects, seeking increases in SFB awards totaling approximately $200,000 for 15 projects, and correcting inaccurate award and payment information for 15 projects.

The results of another review also illustrate the benefits of the close-out process. Specifically, auditors reviewed six construction projects that had remaining award balances between $0 and $10,000. Auditors found that three out of six new construction projects had been completed and reviewed by SFB when performing the close-out process. Therefore, auditors found no recordkeeping errors in any of these new construction projects. However, the other three of these six projects were missing supporting documentation for five transactions totaling $694,315.

Instead of waiting until districts submit a close-out package, SFB should initiate the close-out procedure when the project award amount has all or nearly all been distributed. For example, SFB could adopt a policy of conducting the close-out procedure when it has paid out 95 or 100 percent of the award amount. In addition, SFB should modify its close-out procedure, which currently does not look for duplicate payments or recordkeeping errors.

Internal controls help ensure monies are spent and accounted for appropriately.

SFB can improve its internal control framework—Internal controls help organizations ensure monies are spent appropriately and properly accounted for. The substantial amount of monies SFB manages and pays out to school districts dictates the need for strong controls. Strong internal controls would help ensure school districts are appropriately paid and help provide SFB with good information for budgeting future needs. Without such controls, SFB risks overpaying for school districts' construction, deficiency correction, and emergency correction projects.

SFB should take steps to improve its internal control policies and procedures to help ensure school districts are paid appropriately and to improve the data it uses for budgeting purposes. These steps should occur in the following areas: (1) developing and implementing written policies and procedures, including steps necessary to ensure appropriate payments to districts and regular reconciliations of SFBs' financial information to the state-wide accounting system; (2) establishing a training program for communicating the policies and procedures to key employees; (3) and extending the close-out process to all projects when they end, including a review to detect duplicate payments. Checking for duplicate payments is particularly important for projects where SFB awarded additional monies in excess of the statutory formula amount, which occurred in 23 out of 27 new construction projects in fiscal year 2007. According to SFB policy, when SFB awards such additional monies, any extra monies remaining after the project is completed must be returned to SFB.

Recommendations:

1. SFB should develop and implement written policies and procedures that cover:

   a. Payments to school districts, including all steps necessary to ensure the appropriate payment for projects; and

   b. Regular reconciliation of SFB information against the state-wide accounting system, the Arizona Financial Information System.

2. Once written policies and procedures are developed, SFB should establish a formal training program for employees involved in the processing and disbursement of payments based on the established policies and procedures.

3. SFB should modify its close-out process to:

   a. Initiate the close-out procedure when the project award amount has been all or nearly all distributed instead of waiting to receive a close-out package from the school district; and

   b. Include a review to detect duplicate payments and recordkeeping errors.

FINDING 5

Database controls need improvement

In addition to improving its overall internal control framework, SFB needs to improve controls over its project-tracking database. Because it relies on its database to manage payments to school districts and vendors, controls are necessary to ensure the data is secure and reliable. However, SFB lacks some important controls such as unique passwords for different users and automated edit checks to ensure payments do not exceed approved amounts. These weaknesses appear related to SFB's lack of oversight of information technology (IT) resources and to a contract that delegates too much authority to SFB's IT consultant. SFB should take steps to improve the data it uses for budgeting purposes, such as establishing written policies and procedures and improving security measures. In addition, SFB should consider how best to meet its IT needs and strengthen its current IT consulting contract.

Database controls important to managing payments

SFB uses a project-tracking database to help manage its payments to school districts and vendors as well as to track project information. Specifically, SFB uses the database to determine payment amounts for new construction, deficiency correction, and emergency deficiency correction expenditures. Further, the project-tracking database is the only place where SFB staff maintain detailed payment information by project. In fiscal year 2006, almost $355 million in project payments were made using the database. In addition to calculating and tracking project payments, SFB uses the database to help calculate building renewal amounts based on the statutory formula. In fiscal year 2006, SFB paid out more than $71 million of these monies.

SFB uses a project-tracking database system to determine project payments for new construction, deficiency correction, and emergency deficiency correction projects.

The substantial amount of monies SFB manages and pays out to schools dictates the need for strong IT controls to ensure school districts are appropriately paid and to help provide SFB with good information for budgeting future needs. Similar to the risks of lacking certain internal controls discussed in Finding 4 (see pages 37 through 41), without strong IT controls, SFB risks overpaying school districts for their projects. The State has recognized the importance of IT controls by authorizing the Government Information Technology Agency (GITA) to develop security standards in A.R.S. §41-3504. In addition, industry guidelines, such as those outlined by the Information Technology Governance Institute's COBIT,® reinforce the need for strong IT controls.

SFB lacks some needed controls

Although SFB has developed some controls over its project-tracking database, it lacks controls in several important areas. SFB has complied with a GITA requirement and implemented some controls. However, it lacks a strong overall control framework, and has several weaknesses in specific control objective areas.

SFB has implemented some controls—SFB has complied with GITA's Technology Infrastructure and Security Assessment requirement for assessing compliance with security standards. In addition, it has developed and prioritized a list of future IT projects based on needs. According to SFB officials, this list is used for planning and budgeting purposes. They further state that critical files in the project-tracking database are backed up daily and the backups are stored off-site. Finally, SFB has designed edit checks in some of its project-tracking database input screens, where drop-down menus ensure users can only select from a specific set of options.

Project-tracking database deficiencies appear related to lack of in-house IT staff and over-reliance on a consultant.

Overall control framework lacking—SFB lacks a strong overall control framework. A comparison of SFB practices to the internationally recognized COBIT® guidelines found that SFB only partially addresses the guidelines in all four control objective areas, as shown in Table 5 (see page 45). These deficiencies appear related to the lack of in-house IT staff and the resulting over-reliance on a consultant through a contract that lacks some needed protections.

Specific controls lacking—As illustrated by Table 5 (see page 45), SFB also has weak or missing controls in specific control objective areas, including:

- **Plan and organize**—The first control objective area in the COBIT® framework establishes requirements for documenting the IT system and setting up management practices related to human resources, risk assessment, and managing the quality of the information in the IT system. Weaknesses in the project-tracking database include a lack of written policies and procedures for users, and only limited documentation of how the database works. This lack of documentation could hinder SFB's ability to obtain services from another IT professional or recover from a disaster situation.

Table 5: Analysis of SFB's IT Control Framework

COBIT® Control Objective[1]	Objective Met	Weaknesses in SFB's Framework
Plan and organize— For example: • Define the information architecture • Define processes, organization, and relationships • Manage IT human resources • Assess and manage IT risks • Manage quality	Partially	• Limited documentation of project-tracking database. No overall system documentation or data dictionaries. • A few desk procedures have been developed by SFB staff, but no SFB-developed written policies and procedures exist for users. • No written procedures exist for maintaining the database. • Limited IT knowledge by staff. Only IT consultant and SFB's Director understand how database works. • Database has some built-in edit checks; however, it does not include an edit to prevent staff from overpaying a school district.
Acquire and implement— For example: • Acquire and maintain application software • Enable operation and use • Manage changes • Install and authorize changes	Partially	• Informal process to identify needed changes to database. • Staff not always involved in identifying needs. • Informal system development and change process. • System development and changes not well documented.

Deliver and support—
For example:
• Manage third-party services
• Ensure continuous service
• Ensure systems security
• Educate and train users
• Manage the physical environment
	Partially	• IT consultant contract does not establish software ownership, documentation of system, security measures, system testing and review, or contractor performance criteria.
		• Limited transfer of knowledge and skills from the IT consultant to SFB staff.
		• No formal training program, including training for security awareness.
		• Physical and logical security deficiencies:
		  • Only one user ID and password for all employees using the database.
		  • Users not prevented from making modifications to data or underlying tables.
		  • No written policies ensuring the removal or prevention of nonwork-related software or updating operating system or critical applications.
		• Information technology disaster-recovery plan not up-to-date and lacks some necessary elements.

Monitor and evaluate— For example: • Monitor and evaluate IT performance • Monitor and evaluate internal control • Ensure regulatory compliance • Provide IT governance	Partially	• Informal monitoring and evaluation process of database. • No SFB-developed and approved user policies and procedures to monitor compliance. • IT consultant contract does not establish contractor performance criteria.

[1] IT Governance Institute. *COBIT® 4.0: Control Objectives, Management Guidelines, Maturity Models.* Rolling Meadows, IL: IT Governance Institute, 2005.

Source: Auditor General staff analysis of the SFB's IT control framework to selected *COBIT®* control objectives.

- **Acquire and implement**—The second control objective area in the COBIT® framework establishes requirements related to obtaining, implementing, and modifying IT systems. For example, it specifies that systems should incorporate program change controls to ensure that only authorized changes are made to the application. SFB does not have a formal system to request that its IT consultant make changes to the project-tracking database application or to approve the changes when they have been completed. Instead, SFB relies on e-mails and informal meetings to request changes to its database application.

- **Deliver and support**—The third control objective area in the COBIT® framework provides guidance for ongoing system operations, including controlling day-to-day access to data as well as preparing to ensure business continuity in case of a disaster. For example, access controls ensure that only authorized users can view or change data in an IT system. Common access controls include assigning a unique user name to each employee who uses the database, restricting employees' access so they can only perform data functions needed for their job duties, and requiring users to change their passwords regularly. However, SFB's database has only one user name and password used by all of its employees and access is not restricted by job function. All users can make changes directly to the underlying database, avoiding application controls that help ensure the accuracy of existing data, as well as being able to enter new data in the system.

  Another aspect of this control objective is ensuring continuity of operations after an unexpected event. However, SFB lacks an adequate business continuity or disaster recovery plan. Its plan, which is required by GITA, has not been updated since October 2005 and lacks some necessary elements. A review by the State's Business Continuity Leadership Task Force found that although SFB received a 7.5 out of 10 on a readiness scale, SFB's plan lacks time requirements for recovery, does not address emergency telecommunications, and needs to improve alternative means for data transmission.

The project-tracking database has only one user name and password used by all of SFB's staff.

- **Monitor and evaluate**—The fourth control objective in the COBIT® framework requires management to systematically monitor and evaluate IT performance to help ensure that activities are in line with established policies. However, SFB lacks a process to systematically report database performance issues in a timely manner. Further, its contract with its IT consultant does not establish any contractor performance criteria.

Lack of adequate oversight of IT resources and resulting over-reliance on consultant contribute to weaknesses—SFB uses an IT consultant for day-to-day IT activities as well as for developing and maintaining its project-tracking database. This creates some difficulty for SFB because projects must be weighed against budgetary constraints. SFB's November 2006 contract with its IT consultant establishes an hourly fee of $70. For example, requiring the contractor to provide documentation of the database would require payment of the hourly fee. SFB expects to pay the consultant approximately $45,000 during fiscal year 2007.

Because it lacks documentation of its IT system, SFB cannot adequately oversee its IT consultant. SFB's contract with its consultant does not require him to provide any system documentation. As a result, SFB staff have difficulty establishing appropriate oversight. Further, the lack of documentation would hinder SFB's ability to use another IT professional if needed. Further, with the exception of the Executive Director, SFB's staff do not appear to have an understanding of how the project-tracking database works; therefore, SFB must rely on the IT consultant for any future development.

SFB's contract with the IT consultant does not require providing any system documentation.

SFB should improve IT controls

SFB needs to take several steps to improve its IT controls to help ensure schools are paid appropriately and to improve the data SFB uses for budgeting purposes. Specifically, SFB should improve security measures, make changes to better control payments, establish written policies and procedures, and develop a formal training program. SFB should also fully develop and test its business continuity plan. In addition, SFB should modify its consultant contract, obtain documentation for its database, and consider establishing an in-house IT position.

Steps needed to improve IT controls—SFB needs to strengthen its internal control framework and help ensure that it pays the appropriate amount for projects and has appropriate data for preparing budgetary information. SFB should take steps in the following areas:

- **Security measures**—To strengthen controls over access to SFB's project-tracking database and ensure compliance with GITA standards, SFB should:
    - Use unique account identification numbers and passwords for each employee who uses the database.
    - Restrict database access to only essential users and assign rights using the rule of least privilege required to complete an employee's assigned task(s).
    - Establish an automated edit check on the database that ensures a payment cannot be made in excess of a specific project's remaining budgetary capacity.

- **Written policies and procedures**—SFB should develop written policies and procedures regarding its IT system. These policies should address:

    - Access controls, including logical controls such as password requirements and physical controls.

    - Controls over making changes to the database system, including identifying user needs, identifying necessary changes, documenting changes made, and testing changes before implementation.

    - Workstation management, including restrictions on downloading software from the Internet and requirements to regularly install security patch and virus protection updates.

- **Training**—After written policies and procedures are developed, SFB should establish a formal training program to communicate them to its employees. In addition, SFB should obtain or develop IT security awareness training for its employees to help ensure they understand their role in protecting SFB's data.

SFB should obtain or develop IT security awareness training for its employees.

SFB should develop comprehensive business continuity plan—In addition to improving IT controls, SFB should develop a comprehensive business continuity plan that is updated and tested regularly. To ensure its ability to recover from a disaster, SFB needs to develop, maintain, and test its IT disaster recovery and continuity plans. As previously mentioned, SFB has produced a state-required business continuity plan, but it is missing time requirements for recovery, emergency telecommunications are not addressed, and alternate means for data transmission needs improvement. In addition, the plan has not been updated since October 2005. SFB should update the plan, address weaknesses identified by the task force, and ensure the plan is tested at least annually.

SFB should modify consultant contract and consider its IT needs—SFB should modify its existing IT consulting contract to specify documentation and security requirements. Specifically, SFB should require its current IT consultant to completely document the project-tracking database structure including such information as the database structure, data dictionary, and program code. This documentation needs to provide enough information so that another qualified IT professional could understand how the system works and maintain it in the future. In addition, SFB should modify the contract to establish state ownership of the project-tracking database and require testing and SFB staff review and acceptance of system changes.

SFB needs to carefully consider the best method to meet its IT needs. There are a variety of options available, including an in-house position, a consultant(s), or a combination of the two. An in-house position would allow SFB more flexibility in project planning and could eliminate the need to use a contractor for day-to-day database management. SFB should evaluate its budget capacity, its three vacant positions, and its IT needs to determine the best course of action. SFB also needs to provide appropriate oversight of its IT resources and the project-tracking database to ensure controls are in place.

Recommendations:

1. SFB should strengthen access controls over SFB's project-tracking database by:

    a. Using unique account identification numbers and passwords for each employee who uses the database;

    b. Restricting database access to only essential users and assigning rights using the rules of least privilege required to complete an employee's assigned task(s); and

    c. Establishing an automated edit check on the database that ensures a payment cannot be made in excess of the remaining budgetary capacity of a specific project.

2. SFB should develop written policies and procedures for its IT system to address:

    a. Access controls;

    b. Controls over making changes to the database system, including identifying user needs, identifying necessary changes, documenting changes made, and testing changes before implementation; and

    c. Work station management, including restrictions on downloading software from the Internet and requirements to regularly install security patch and virus protection.

3. Once written policies and procedures are developed, SFB should establish a formal training program that:

    a. Communicates SFB policies and procedures to its employees; and

    b. Includes security awareness training to help ensure employees understand their role in protecting SFB data.

4. SFB should develop a comprehensive business continuity plan by:

    a. Updating and maintaining its plan;

    b. Addressing weaknesses identified by the Business Continuity Leadership Task Force; and

    c. Testing the plan at least annually.

5. SFB should modify its IT consultant contract to:

    a. Require documentation of the database system, including such information as database structure, data dictionaries, and program code;

    b. Establish state ownership of the project-tracking database; and

    c. Require testing and SFB staff review of system changes.

6. To meet its IT needs, SFB should consider converting a vacant position to an IT position, using a consultant(s), or a combination of the two.

OTHER PERTINENT INFORMATION

As part of the audit, auditors gathered other pertinent information regarding SFB's awards of monies for school districts' emergency deficiency correction projects. As shown in Table 6 (see page 52), SFB has awarded monies for 14 projects totaling approximately $8.4 million since its inception in fiscal year 1999.

Emergency—A need that seriously threatens the functioning of the school district, the preservation or protection of property, or public health, welfare, or safety.

Source: A.R.S. §15-2022.

The Legislature established the Emergency Deficiencies Correction Fund (Fund) to help districts manage serious needs in excess of their current budgets. SFB is responsible for administering the Fund, including transferring monies into it from the Deficiencies Correction Fund and New School Facilities Fund to fulfill the requirements of A.R.S. §15-2022. However, SFB may not transfer these monies if doing so would disrupt any approved capital projects.

Process for obtaining emergency funding—When a school district has an emergency for which it does not have adequate monies, the district may apply to SFB for emergency deficiency correction monies. The district must disclose any insurance or building renewal monies that would be available to pay for the emergency. SFB staff prepare a summary and recommendation for the Board's consideration, and the Board determines whether or not to fund the project.

SFB has not adopted criteria for decisions to award emergency monies, but relies on A.R.S. §15-2022 for guidance. As directed by this statute, SFB must consider:

- **Nature of the threat**—Statute defines an emergency as a threat to the district's functioning, preservation or protection of property, or public health, welfare, or safety. For example, in September 2006, SFB approved monies to correct electrical service to a school building. The existing service did not meet the electrical code, and the building was a fire hazard.

- **Need in excess of the district's budget**—Statute further defines an emergency as a serious need that exceeds the district's current budget. For example, in June 2006, SFB approved monies for the replacement of kitchen equipment that did not meet safety standards because the district did not have any unrestricted capital, building renewal, or other funding to contribute to the project.

- **SFB's available funds**—Statute authorizes transfers into the Emergency Deficiency Correction Fund only if transferring the monies from the Deficiencies Correction Fund or the New School Facilities Fund does not disrupt current capital projects already awarded. The Emergency Deficiency Correction Fund does not have a dedicated funding source or specific appropriation. SFB, not the Legislature, transfers monies to the Fund when needed. During fiscal year 2006, SFB transferred $10 million into the Fund, and the Fund's ending fund balance totaled approximately $4.1 million. Statute allows districts to incur debt to correct emergencies if SFB determines that it has insufficient monies to transfer to the Fund. SFB's Executive Director reported that SFB has not yet denied a project because of insufficient funding.

Table 6: SFB Schedule of Emergency Project Awards
Fiscal Years 1999 through 2006
(Unaudited)

Project Description	Award Amount
Replaced building damaged by fire	$7,287,661
Replaced three corroded and leaky septic systems	457,562
Replaced fire alarm system	129,203
Treated mold and repaired roof	127,426
Replaced split and cracked roof	119,650
Restored and completed electrical service	63,533
Replaced septic system as required by Arizona Department of Environmental Quality	47,367
Replaced kitchen hood as required by the State Fire Marshal	38,912
Installed water treatment system to lower arsenic levels in existing well	27,623
Evaluated and repaired well	25,243
Replaced roof in modular building because of heavy monsoon rain damage	25,000
Re-activated abandoned well	25,000
Study to evaluate the structural integrity of buildings	20,000
Canceled request for septic system[1]	1,662
Total	$8,395,842

[1] SFB approved a district's request to replace a septic system; however, the district later learned that a water company planned to construct a nearby sewer system. Therefore, the district requested that its project be canceled with the exception of costs already incurred.

Source: Auditor General staff analysis of SFB's *Emergency Fund Balance* report dated October 10, 2006, and board meeting minutes for fiscal years 1999 through 2006.

In addition to the statutory considerations, SFB has also considered:

- **Alternatives to emergency funding**—When reviewing a project, SFB considers whether the District could use other monies, such as insurance proceeds, or another approach to address the need. For example, in June 2003 SFB considered whether insurance would cover a building replacement because the need for replacement was discovered in an investigation conducted after a fire damaged a roof at the school.

- **Whether the need is unexpected**—SFB determines if the need was caused by an unexpected event, like a flood or fire, and if it is beyond the district's current budget. For example, in November 2005, SFB denied funding to improve the access road to a school, stating that the need was well-known and should have been anticipated and was not caused by an unexpected event.

Emergency projects awarded—During fiscal year 2006, SFB awarded emergency monies for five requests, denied one request, and canceled one request. As illustrated in Table 6, page 52, from fiscal years 1999 to 2006, the SFB awarded emergency monies for 14 projects totaling approximately $8.4 million. For example:

- SFB's first emergency project award, in 2003, assisted Tuba City Unified School District with replacing a building after a fire damaged the building's roof. The district's insurance company had determined that the policy did not provide coverage for the damage. Specifically, after the fire the district hired a consultant to inspect the building, the consultant determined that the building structure was significantly deteriorated because of the building's age (30 years) and overall condition, not associated with the fire, and that the entire building should be replaced.

Other projects that SFB has awarded emergency monies for include repairing wells, replacing septic systems, repairing electrical systems, and repairing roofs.

SUNSET FACTORS

In accordance with A.R.S. §41-2954, the Arizona Legislature should consider the following 12 factors in determining whether the School Facilities Board (SFB) should be continued or terminated.

1. **The objective and purpose in establishing the School Facilities Board.**

   The School Facilities Board was established in 1998 to administer a capital finance program created when Governor Hull signed legislation known as Students FIRST (Fair and Immediate Resources for Students Today). SFB was created in an effort to address the Arizona Supreme Court determination that the State is obligated to meet the constitutional requirement that it establish and maintain a general and uniform public school system. To define general and uniform, legislation was passed creating minimum adequacy guidelines to prescribe an adequate level a school must achieve to meet the general and uniform clause. The prescribed adequate level was established through minimum adequacy guidelines that outline the requirements Arizona Schools Facilities must meet.

   SFB defines its mission as follows:

   "To provide financial and technical assistance to help ensure that school districts maintain building and equipment at minimum adequate standards so that students can achieve academic success."

   SFB is responsible for administering four capital funds that provide monies to school districts for various purposes. These funds are as follows:

   - The Deficiencies Correction Fund provides funding for school districts to bring their facilities up to established minimum adequacy guidelines.

   - The New School Facilities Fund provides school districts with monies to purchase land and build schools to accommodate student enrollment growth.

   - The Building Renewal Fund provides monies for the purpose of maintaining the adequacy of existing schools.

- The Emergency Deficiencies Correction Fund helps districts manage needs that threaten district functioning, preservation or protection of property, or public health, welfare, or safety.

Under A.R.S. §15-2021, the deadline for correcting deficiencies using the Deficiencies Correction Fund monies was June 30, 2006, and Laws 2005, Chapter 287, Section 6, terminated the Fund as of July 1, 2006. As of June 7, 2007, only one district was still working to finish its deficiency projects.

2. **The effectiveness with which the School Facilities Board has met its objective and purpose and the efficiency with which it has operated.**

SFB has generally been effective and met its purpose of managing the statutorily established capital funds, but could improve its effectiveness in some areas. It manages programs that help districts maintain schools that meet minimum adequacy guidelines. This audit identified several ways in which SFB is operating effectively:

- **Deficiency corrections**—SFB managed the deficiency corrections program to assess school facilities and provide monies to school districts to bring the facilities up to minimum adequacy guidelines. SFB identified existing deficiencies in school buildings and then worked with school districts and their contractors as well as through project supervisors employed by SFB to correct the deficiencies. As of April 2006, SFB had used deficiency program monies for a total of 9,002 projects and paid out $1.3 billion for deficiency corrections. Deficiency projects included adding classroom space to existing schools where districts did not have the required number of square feet per student and correcting quality deficiencies where school district facilities did not comply with the established minimum adequacy guidelines.

- **New construction**—As of June 7, 2007, SFB had awarded 328 new school projects to accommodate student enrollment growth. SFB staff review each new school's design before the school is constructed to ensure that the facility will meet the minimum adequacy guidelines. SFB staff also review and evaluate construction projects to determine the amount of additional monies, if any, required to meet the minimum adequacy guidelines.

- **Building renewal**—SFB provides monies to nearly all school districts—187 out of 215 in fiscal year 2006—to enable them to maintain the adequacy of their facilities. As part of this program, SFB staff are required to inspect all schools in the State to collect data needed to determine distributions of building renewal monies. Starting in May 2004, SFB liaisons have conducted site visits to ensure that school districts are completing tasks necessary to prevent deterioration of buildings and equipment. In addition, to help districts comply with a statutorily established reporting requirement, SFB introduced a new Web-based computerized program for districts to submit their 3-year building renewal plans. According to SFB staff, district officials have given favorable feedback on the new program's ease of use, convenience, and effectiveness (see Finding 3, pages 31 through 36).

However, this audit also found several ways in which SFB could improve its effectiveness. For example:

- Increasing demands on the General Fund—SFB's responsibilities include administering and distributing new school construction monies to accommodate student growth and ensure school facilities meet the established minimum adequacy guidelines. Rising construction costs and student enrollment are already placing increasing demands on the New School Facilities program and on the General Fund, which is quickly becoming the main source of funding for new school construction. Recent SFB interpretations of the minimum adequacy guidelines will potentially further raise the demand for General Fund monies. Because SFB awards of additional monies to pay for the costs of these interpretations do not appear to fall within the four statutory reasons for SFB to award additional monies, the Board should seek a formal Attorney General opinion to determine if its actions are within the scope of its authority, and then comply with the opinion.

- Oversight of building renewal expenditures—SFB's responsibilities include administering and distributing building renewal monies to school districts. As prescribed by A.R.S. §15-2031, monies from the Building Renewal Fund can be used to pay for only items or services that will help maintain or extend the useful life of school facilities. However, SFB staff do not have a process in place to review the districts' annual building renewal expenditure reports and ensure monies are used as prescribed in statute. Because some districts have used building renewal funds inappropriately, SFB should establish and implement policies and procedures for its staff to review expenditure reports. In addition, SFB should report inappropriate expenditures to the State Superintendent of Public Instruction as required by law.

- Internal controls over payments—SFB, one of the State's highest recipients of appropriated monies, distributes hundreds of millions of dollars annually to school districts and vendors for school districts' projects including new school construction, deficiency correction, and emergency projects. SFB staff need to improve their internal controls over these payments. Although SFB staff have implemented some internal controls over managing and paying for projects, other controls are lacking, resulting in a risk of paying more for school projects than the Board awarded. SFB should take steps to improve its internal control policies and procedures to help ensure it does not overpay for school districts' projects.

- **Database controls**—SFB uses a project-tracking database to help manage its payments to school districts and vendors and track project information. Although SFB has developed some controls over its database, it lacks a strong overall control framework and has several weaknesses. SFB needs to improve its IT controls to help ensure that school districts are paid appropriately and information used for budgeting purposes is accurate.

3. **The extent to which the School Facilities Board has operated within the public interest.**

SFB has generally operated within the public interest by providing financial and technical assistance to help school districts build and maintain school buildings that meet minimum adequacy guidelines. SFB has distributed monies, provided inspections of districts' buildings, reviewed capital plans, and provided routine preventative maintenance guidelines to school districts. Further, SFB has developed a Web site to provide information on its programs. The Web site provides information on when a district is eligible to receive funding, forms needed to apply for funds (when applicable), and instructions. In addition, SFB developed a Web-based program that allows districts and the public to view projects, funds, and expenditures.

4. **The extent to which rules adopted by the School Facilities Board are consistent with the legislative mandate.**

SFB does not have general rulemaking authority but it is required to promulgate rules to establish minimum adequacy guidelines for school facilities. Specifically, 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, SFB was required to adopt guidelines in nine areas:

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

- Other facilities and equipment that are necessary and appropriate to achieve the academic standards prescribed pursuant to A.R.S. §15-203, subsection A, paragraphs 12 and 13, and §15-701 and 15-701.01.

SFB's rules address all nine mandatory areas.

According to the staff of the Governor's Regulatory Review Council (GRRC), there are no rules on the subjects of the following two statutes:

- "A.R.S. §15-2022(A): The Board is required to administer an emergency deficiencies correction fund and distribute monies in accordance with the rules of the Board to school districts for emergency purposes."
- "A.R.S. §41-1033(A): The Board is required to prescribe the manner and form for a person to petition the agency to request the making of a rule or review of an agency practice or substantive policy statement that the petitioner alleges to constitute a rule."

However, according to GRRC staff, "the Board does not have general rulemaking authority." As noted in Sunset Factor 8 (see page 60), the Legislature is considering a bill that would give the Board this authority.

5. **The extent to which the School Facilities Board has encouraged input from the public before adopting its rules and the extent to which it has informed the public as to its actions and their expected impact on the public.**

   SFB has complied with open meeting laws by posting public meeting notices at least 24 hours in advance at the required locations and making meeting agendas available to the public, and having a statement of where meeting notices will be posted on file with the Secretary of State. SFB provides notices of board meetings and agendas on its Web site and outside its office. SFB invites public input and comments on its actions through board meetings or submitting letters or phone calls to SFB staff. Also, SFB encourages public input prior to adopting rules by publishing proposed rules and final rule makings in the Arizona Register. For example, in October 2006, SFB published a change to rule R7-6-302.

6. **The extent to which the School Facilities Board has been able to investigate and resolve complaints that are within its jurisdiction.**

   This factor does not apply because the School Facilities Board has no statutory authority to investigate and resolve complaints. However, SFB retains an Assistant Attorney General who represents and provides counsel to the Board at its meetings and represents SFB during legal actions.

7. **The extent to which the Attorney General or any other applicable agency of state government has the authority to prosecute actions under enabling legislation.**

   This factor does not apply because the School Facilities Board's enabling legislation does not establish any authority that would require prosecuting actions.

8. **The extent to which the School Facilities Board has addressed deficiencies in its enabling statutes, which prevent it from fulfilling its statutory mandate.**

   According to GRRC staff, "the Board does not have general rulemaking authority, which would usually appear in the statute that lists the agency's powers and duties, in this case A.R.S. §15-2002." During the 2007 legislative session, SFB sought general rulemaking authority and the Legislature considered House Bill 2241, which would grant SFB this authority, among other changes. However, the bill did not pass.

9. **The extent to which changes are necessary in the laws of the School Facilities Board to adequately comply with the factors in the sunset law.**

   Because circumstances no longer require an audit of SFB's bonds, it may be time to repeal the statutes requiring the audit. A.R.S. §§15-2092 and 15-2063 require that an annual audit of SFB's revenue bond receipts and debt service, including all accounts and sub-accounts established for these funds, must be conducted by a certified public accountant within 90 days of the end of each fiscal year. The deficiency corrections program has ended. In fiscal year 1999 through August 2005, SFB issued a total of approximately $1.8 billion in bonds to pay for the cost of correcting deficiencies, and after principal payments through fiscal year 2006, the remaining balance is approximately $877 million. However, because the Legislature prefers to pay for schools on a cash basis, SFB has no plans to issue additional bonds. Therefore, this audit no longer provides meaningful information. The Legislature should consider replealing A.R.S. §§15-2092 and 15-2063 to remove this requirement.

10. **The extent to which the termination of the School Facilities Board would significantly harm the public health, safety, or welfare.**

    Terminating SFB could result in violating the 1994 *Roosevelt v. Bishop* decision to correct inequities between school districts in the provision and upkeep of school facilities.[1] In addition, it would result in the need to pay or retire bonds issued by SFB earlier than originally planned.

    In *Roosevelt v. Bishop*, the Arizona Supreme Court wrote that because the then-present funding scheme created disparities among schools, it was not in compliance with Arizona Constitution Article XI, Section 1.A., which requires the

1 *Roosevelt Elementary School District No. 66 v. Bishop, (Ariz., 1994) No. CV-93-0168-T/AP.*

Legislature to enact laws to provide for the establishment of a general and uniform public school system. SFB is responsible for administering state monies in order to enable all Arizona school districts to build and maintain school facilities that meet minimum adequacy standards, regardless of each district's property wealth. If SFB were terminated, responsibility for administering these monies would have to be transferred to another entity.

In addition, according to A.R.S. §41-3008.19, SFB can only be terminated if there are no outstanding bonds, but SFB has outstanding bonds. SFB issued these bonds to provide funds for the Deficiency Corrections programs. The bonds are referred to as School Improvement Revenue Bonds, Qualified Zone Academy Bonds, and State School Trust Revenue Bonds. After principal payments through fiscal year 2006, the remaining balance is approximately $877 million, and the bonds will not be fully paid off until 2021 (see Introduction, pages 1 through 13, for more information on these bonds). The State would have to pay or retire the bonds before terminating SFB.

11. **The extent to which the level of regulation exercised by the School Facilities Board is appropriate and whether less or more stringent levels of regulation would be appropriate.**

    This factor does not apply because the School Facilities Board has no regulatory authority.

12. **The extent to which the School Facilities Board has used private contractors in the performance of its duties and how effective use of private contractors could be accomplished.**

    SFB used several types of professional and private contractors to provide various services related to the deficiency correction program. For example, according to SFB staff, SFB used private building inspectors for the assessment of schools as required by A.R.S. §15-2002. SFB reports that it also used private project management firms and construction services for the deficiency correction program as prescribed by A.R.S. §15-2002. With the close of the Deficiencies Correction Fund as of July 1, 2006, these services are no longer being contracted by the School Facilities Board for the Deficiencies Correction Fund.

    SFB uses professional and private contractors to provide information technology (IT) related services and land acquisition expertise. SFB officials explained that contracting these services saves the State monies in health benefits, workmen's compensation, and retirement. However, the audit identified areas for improvement in SFB's use of a consultant for IT services. Specifically, the audit found that SFB should improve oversight of the consultant and modify the contract to specify documentation and security requirements, establish state ownership of SFB's project-tracking database, and require testing and SFB staff review and acceptance of changes to the IT system.

SFB could improve its oversight of building renewal monies by contracting with an auditing firm that specializes in construction services for the review of building renewal expenditures. SFB administers and distributes building renewal monies to school districts. These monies can only be used to pay for items or services that will help maintain or extend the useful life of a building. SFB needs to provide greater oversight to help ensure school districts spend building renewal monies in accordance with statute. SFB should consider the relative costs of contracting for the expenditures review versus doing the expenditures review in-house.

APPENDIX A

Question 1: How many districts take advantage of school designs that are already built so that the district does not incur the cost of an architect?

Some districts use the same school design when building new schools. Of the 38 school districts that had recently built a school using monies from SFB and responded to the auditors' survey, 15 reported using the same prototypical design for multiple school construction projects. However, even prototypical designs have to be adjusted for a particular project. For instance, a school district reported that it adjusts a prototype design to accommodate different land layouts and adjusts outside finishes so the schools will not look the same. Further, districts may need to create new school designs because of recent SFB design changes. For example, in November 2006, SFB adopted a policy establishing the maximum amount of outside linear square footage it is willing to award monies for. As a result, districts may need to redesign their existing prototypes. For example, one district that uses a prototype reported that it will design its next school to conform to the changes in SFB's guidelines.

Some of the advantages of using prototypical designs include cost savings and an expedited review process. The amount of money SFB awards to districts for engineering and architectural fees varies and ranges from 4.3 to 8.9 percent of the project cost, depending on the project's total cost and complexity. For instance, in January 2007, SFB awarded a district 5.5 percent, or $579,606, in architect and engineering fees based on the project's estimated cost of $10.6 million. These fees include the school design fee. According to SFB's staff architect, while using the same design does not translate into a substantial amount of savings, prototypical designs that have already been reviewed can expedite the review process. As a result, districts can save time by starting the project more quickly, and more promptly accommodate student growth. In addition, by speeding up the process for beginning a new project, the district can limit the impact of construction market inflation, thereby saving money.

QUESTIONS and ANSWERS

Summary

At the start of most performance audits and sunset reviews, the Office of the Auditor General sends members of the Legislature and legislative staff a letter soliciting their input regarding areas of concern or interest. This appendix provides answers to seven legislative and legislative staff questions raised during the audit regarding the design of school facilities and the accuracy of SFB's financial information.

To answer the first four questions, auditors e-mailed a survey to the superintendents and/or their staff of all 239 public school districts in the State. Only districts that had built a school between fiscal years 2004 and 2006 with monies from SFB were asked to respond to the survey. Altogether, auditors received valid responses from 66 districts, of which 38 met this criterion.

Question 2: Are school designs incorporating energy-efficient control mechanisms?

Sixteen of 38 responding school districts reported incorporating energy-efficiency control mechanisms beyond required standards when building a school during fiscal years 2003 through 2006. To obtain a building permit, design professionals must comply with the local energy code. According to A.R.S. §34-451, A.R.S. §41-790(3), and the Governor's Executive Order 2005-05, all state-owned or funded buildings, structures, and facilities, including school facilities, must follow energy codes consistent with recommended standards of the American Society of Heating, Refrigerating, and Air-Conditioning Engineers (ASHRAE). In addition, schools in 16 jurisdictions, including Phoenix, Tucson, and Pinal County, must also comply with the International Energy Conservation Code. The standards address such concepts as minimum R-values of roofs and walls and minimum shading coefficients for windows. Some of the mechanisms districts reported using to conserve energy include dual-pane windows, insulated exterior doors, energy management control systems, and occupancy sensors for lighting controls. However, two districts reported that they were not able to add energy-efficiency control mechanisms beyond the standards because SFB cannot pay for them. According to SFB rules that establish the minimum adequacy guidelines that govern what SFB will pay for, new school facilities should include, where reasonable, energy conservation upgrades that will provide savings in excess of their cost within 8 years.

In 2005, Governor Napolitano established the goal that all state-funded buildings will be built to a Leadership in Energy and Environmental Design (LEED) silver standard. The U.S. Green Building Council constructed this standard for developing high-performance sustainable buildings. Buildings earn points based on the following criteria: sustainable sites, water efficiency, energy and atmosphere, materials and resources, indoor environmental quality, and innovation and design. Buildings can be certified as basic LEED, silver, gold, or platinum. According to the Council of Educational Facility Planners International, as of December 2006, only one high school in Arizona had reached the silver standard. A building needs at least 26 points to earn the basic certification. According to SFB staff, a school design can obtain 16 points without incurring additional costs. However, districts may need an additional $9 per square foot to earn 10 more points and satisfy all prerequisites.

Question 3: How many districts qualify and build a school for certain grade levels and later switch the grade level they serve?

Two of 38 responding districts reported permanently reconfiguring schools that were constructed during fiscal years 2003 through 2006. One district explained that it reconfigured schools because of its growth. Specifically, this district had reconfigured its elementary schools to serve grades kindergarten (K) to 5 instead of the planned K to 6, and reconfigured its middle school to serve grades 6 to 8 instead of 7 to 9. Another district explained that it had originally applied for new construction monies from SFB for a grade K-to-5 school and a middle school. However, the project was reconfigured to serve students in grades K to 8, allowing for accelerated construction of the needed space. In addition to these two districts, SFB identified a third district that applied for and received approval to permanently reconfigure a new school from a grade 7-to-8 middle school to a grade K-to-8 elementary school.

In addition, 3 of 38 responding districts reported temporarily serving grades other than what was intended.[1] For example, one district reported using its K to 8 schools to serve grades K to 7, with the intent of adding the 8th grade the following year. Another district reported that it anticipated needing a grade K-to-8 school, but opened with a grade 5 to 7 configuration. However, the district expected to use the facility to serve grades K to 8 the following year.

Question 4: How many school designs do not comply with city zoning regulations?

To answer this question, auditors asked districts whether their designs had been rejected by the city because they did not meet zoning requirements. Only one of the 38 responding school districts reported having a design that did not comply with zoning regulations. Specifically, the district reported that it had to make changes to its school design costing the district more than $180,000 to meet city zoning requirements. Additionally, six districts reported that they are having some related problems. For example, one district reported that the city required landscaping and setbacks to meet local building codes. Another district reported that although the district was not required to comply with zoning requirements, it had to use local monies to address dust control, student drop-off, and other issues not adequately addressed by SFB funding.

Question 5: Does the School Facilities Board's financial information accurately represent the activities that occur within its funds?

Overall, SFB's reporting of financial information in its annual report and annual budget submission appears to reasonably reflect the activities that occurred within its funds. However, expenditure information presented by SFB varies depending on whether the information comes from the State's accounting system, called the Arizona Financial Information System (AFIS), or SFB's project-tracking database. Auditors identified differences between AFIS and the project-tracking database, including differences in timing of when transactions were recorded on the two systems and the method of accounting for transactions. Differences between the project-tracking database and AFIS led to a discrepancy in SFB's fiscal year 2006 annual report. Specifically, the report contained expenditure information for the Deficiencies Correction Fund, but the total amount reported in the appendix differed from the amount reported in the text. The appendix contained detailed information by school based on data in SFB's database, while the information in the text was obtained from AFIS. The difference between the two numbers was primarily because of the return of monies from districts. The AFIS amount was properly recorded as a reduction of expenditures; however, SFB's database did not have a proper recording of the amount.

1 A fourth district also reported a temporary reconfiguration. However, this was the same district SFB identified as having been approved for a permanent reconfiguration. To avoid duplication, auditors included this district only in the number of districts that permanently reconfigured their schools.

Auditors also identified minor errors in SFB's fiscal year 2008 budget request such as including a requested increase and decrease in the wrong expenditure category. In addition, SFB relies on its project-tracking database to develop estimates for its budget requests. Auditors identified weaknesses in SFB's internal control framework and IT controls as well as errors in the database, which could affect the reliability of information used in preparing budget requests (see Findings 4 and 5, pages 37 through 50). For example, auditors' review of 11 projects with negative balances on the project-tracking database showed that most negative balances resulted, in part, from recordkeeping errors. However, the overall reporting of expenditure information in SFB's fiscal year 2008 budget request appeared reasonably accurate and generally agreed to AFIS.

Question 6: Why do disbursements of new construction monies vary from SFB staff estimates?

SFB staff's methodology for estimating future new construction needs appears reasonable. According to SFB staff, estimating these needs is challenging because SFB has no control over when a district will submit requests for payment. SFB does not give school districts the amount of a new school construction award in advance, but rather gives districts a portion of the money in advance to pay for design costs and then reimburses districts for other construction expenditures throughout the construction process. To arrive at estimates for the total amount SFB will pay in a particular fiscal year, SFB staff rely on analyzing historical payment data to determine the pattern of when payments are typically made for construction projects. Based on the historical pattern, for SFB's fiscal year 2008 budget request SFB staff estimated that payments would total 5 percent of each project award in the year the project was approved, 27.2 percent in the second year, 36.5 percent in the third year, and other percentages in subsequent years over the life of the project. The staff applied these percentages to the total award amounts for all uncompleted projects.

An additional challenge SFB faces in estimating its needs is that significant changes made to a project and other factors can change the estimates for a given project over time. To develop needs estimates, SFB staff report that they include all uncompleted projects that have received at least a conceptual SFB approval. However, a project's scope can change between conceptual approval and final SFB approval, which would affect the estimated costs. In addition, some projects with shorter timelines may not follow the historical spending pattern.

Question 7: Do SFB's enrollment projections match actual student enrollment?

Statute requires SFB to analyze student enrollment projections when determining if it should award funds to a school district for a new construction project. A.R.S. §15-2041(B) requires districts to develop and annually update a capital plan, which includes the district's student enrollment projections and a description of needed schools. If the capital plan indicates that a district will need more space to accommodate its projected student enrollment growth, SFB awards funding for new space or a new facility. To determine awards, SFB staff review and analyze district enrollment projections, and may develop projections independently. Based on its analysis, SFB staff recommend either approving or denying district requests for funding to build additional space.

SFB's projections were inaccurate in at least one fast-growing district. Specifically, SFB records indicate that the Maricopa Unified School District's fiscal year 2005 capital plan requested monies for additional classroom space, but SFB staff recommended denying the request. Both the district's and SFB staff's projections were inaccurate—the district overestimated enrollment growth while SFB staff underestimated it—but the district had sufficient growth to have been awarded monies for additional space. SFB has since awarded funding to the district for a project to address its growth.

To better predict student growth, in 2006 SFB hired a demographer. With the addition of a staff demographer, the Executive Director believes SFB will better project student enrollment. The demographer is using a well-known student enrollment projection method called the "cohort-survival method." This method works well in a relatively stable district. In rapid growth areas, this method should be augmented by considering additional factors. SFB's demographer states that he is using the cohort-survival method augmented with housing information to make his projections.

AGENCY RESPONSE

STATE OF ARIZONA
SCHOOL FACILITIES BOARD

Governor of Arizona
Janet Napolitano

Executive Director
John Arnold

August 13, 2007

Debbie K. Davenport
Auditor General
2910 North 44th Street
Phoenix, Arizona 85008

Dear Ms. Davenport,

The School Facilities Board (SFB) staff would like to thank you and compliment your staff on the professionalism shown during the sunset audit of the SFB. We appreciate the open dialogue and the recommendations offered in the audit. SFB staff agrees with all of the findings in the audit. We offer the following comments on the recommendations.

Finding #1

The SFB will accept the finding and the recommendation will be implemented. However, SFB staff would point out that the Attorney General has already issued an Opinion on Inflation Adjustment of Square Footage Cost for New Construction (see Opinion #I04-011 dated December 3, 2004). Once that Opinion was received, the Board modified its policies on inflation adjustments in accordance with the Opinion. We have worked with our assigned assistant attorney general to ensure that our policies conform to the statute, rules and the existing Opinion. Therefore, SFB staff believes that asking for an additional Opinion is extraordinary and repetitive. However, SFB staff will request another formal opinion as recommended.

Finding #2

The SFB staff agrees with this finding but cannot implement the recommendation. Further, the SFB staff disagrees with the stated purpose of the recommendation. While the unpredictability of the provided building renewal appropriations has created district management difficulties, the key purpose in modifying the building renewal formula should be ensuring that sufficient resources are provided to maintain facilities at the appropriate levels. With the creation of Students' FIRST, the Court transferred the responsibility to maintain the existing school inventory to the State. That inventory, consisting of over 10,000 buildings and 110 million square feet, is a vital asset to the State that must be properly maintained.

By ignoring the wide ranging differences within that building inventory, the current formula misallocates resources causing some districts to be over funded in their building renewal needs

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and others to be potentially under funded. SFB staff agrees that the current system should be studied and modified, but not with the intent of easing management. The purpose should be to find a system that will appropriately fund the required maintenance and building renewal.

Finding #3

SFB staff agrees with the finding and will implement the recommendations. In the course of reviewing building renewal expenditures, the SFB staff and Board will have to determine appropriateness for expenditures that are not specifically clarified by statute. For example, the report suggests that both playground equipment and irrigation improvements are inappropriate expenditures. Depending on the specific nature of the expenditure, SFB staff believes that both of these expenditures would be considered either an upgraded system or an infrastructure cost and would therefore be appropriate.

Finding #4

SFB staff agrees with this finding and will implement the recommendations.

Finding #5

SFB staff agrees with this finding and will implement the recommendations.

As stated above, the SFB will work to implement all the recommendations in the report. We look forward to working with your staff during that process.

Sincerely,

John Arnold

AUDITOR GENERAL REPLY TO AGENCY RESPONSE

The following auditor comments are provided to address certain statements made by the School Facilities Board related to Finding 1, Recommendation 1:

- The Auditor General disagrees that implementing this recommendation would be extraordinary and repetitive (see page 1 of the response). The Attorney General's 2004 opinion addressed whether the inflation adjustment authorized by A.R.S. §15-2041 could be used after a project was approved. The opinion found that the inflationary increase, according to the statute, is the annual adjustment for market conditions based on an index identified or developed by JLBC. The additional awards discussed on page 22 of the report are not based on the annual JLBC adjustment, but are calculated to pay for certain design features. Although SFB believes these additional awards are necessary to compensate for rising costs, they appear to go beyond the JLBC inflation adjustment identified in the 2004 opinion.

Performance Audit Division reports issued within the last 24 months

05-06 Department of Revenue—Audit Division
05-07 Department of Economic Security—Division of Developmental Disabilities
05-08 Department of Economic Security—Sunset Factors
05-09 Arizona State Retirement System
05-10 Foster Care Review Board
05-11 Department of Administration—Information Services Division and Telecommunications Program Office
05-12 Department of Administration—Human Resources Division
05-13 Department of Administration—Sunset Factors
05-14 Department of Revenue—Collections Division
05-15 Department of Revenue—Business Reengineering/Integrated Tax System
05-16 Department of Revenue Sunset Factors
06-01 Governor's Regulatory Review Council
06-02 Arizona Health Care Cost Containment System—Healthcare Group Program
06-03 Pinal County Transportation Excise Tax
06-04 Arizona Department of Education—Accountability Programs
06-05 Arizona Department of Transportation—Aspects of Construction Management
06-06 Arizona Department of Education—Administration and Allocation of Funds
06-07 Arizona Department of Education—Information Management
06-08 Arizona Supreme Court, Administrative Office of the Courts—Information Technology and FARE Program
06-09 Department of Health Services—Behavioral Health Services for Adults with Serious Mental Illness in Maricopa County
07-01 Arizona Board of Fingerprinting
07-02 Arizona Department of Racing and Arizona Racing Commission
07-03 Arizona Department of Transportation—Highway Maintenance
07-04 Arizona Department of Transportation—Sunset Factors
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Arizona State Land Department