New Jersey State Legislature
Office of Legislative Services
Office of the State Auditor

New Jersey Schools Development Authority

July 1, 2007 to February 28, 2010

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State Auditor

New Jersey State Legislature

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Enclosed is our report on the audit of the New Jersey Schools Development Authority for the period of July 1, 2007 to February 28, 2010. If you would like a personal briefing, please call me at (609) 292-3700.

Stephen M. Eells
State Auditor
June 10, 2010

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New Jersey Schools Development Authority

Scope

We have completed an audit of the New Jersey Schools Development Authority (SDA) for the period July 1, 2007 to February 28, 2010. Our audit was limited to the prioritization process and sequencing of school facility projects in SDA districts (former Abbott districts) and the management and processing of change orders. Significant issues relating to cash receipts, energy rebates, and demonstration project consultants noted in our prior report were not included in this review.

The operations of the SDA are funded primarily from bonds. Since program inception, $8.1 billion in bond proceeds have been received from the $12.5 billion authorized by law. Change orders processed during the audit period totaled $130 million. The mission of the SDA is to create a more promising future for the children of New Jersey by providing safe, healthy, and sustainable schools that create a positive learning environment and strengthen the community.

Objectives

The objectives of our audit were to determine whether the 2008 Strategic Plan for SDA districts effectively prioritized school projects most in need and whether change orders were reasonable, necessary, and recorded properly in the SDA's accounting system. We also tested for resolution of the significant conditions included in our scope that were noted in our prior report dated March 8, 2006.

This audit was conducted pursuant to the State Auditor's responsibilities as set forth in Article VII, Section I, Paragraph 6 of the State Constitution and Title 52 of the New Jersey Statutes.

Methodology

Our audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States.

In preparation for our testing, we studied legislation, administrative code, and policies of the SDA. Provisions that we considered significant were documented and compliance with those requirements was verified by interview, observation, and through our samples of financial transactions. We also read the board minutes, reviewed financial trends, and interviewed agency personnel to obtain an understanding of the organization and its internal controls. In addition, we reviewed annual and internal audit reports issued by public accounting firms contracted by the SDA.

A nonstatistical sampling approach was used. Our samples of financial transactions were designed to provide conclusions about the validity of transactions as well as internal control and compliance attributes. Transactions were judgmentally selected.

To ascertain the status of findings included in our prior report, we identified corrective action, if any, taken by the SDA and performed tests to determine if the corrective action was effective.

Conclusions

We found that some of the projects included in the 2008 Strategic Plan may not have been the most critically needed since they were not subject to the prioritization process mandated by law or their inclusion was to fulfill the plan's requirement that every district receive at least one project. We found the change orders included in our testing were necessary and were recorded properly in the accounting system. However, in making this determination, we noted certain internal control weaknesses relating to supporting documentation that hindered our ability to determine if costs were reasonable. We also found that the SDA has resolved most of the significant issues that we reviewed in our prior report. The issues concerning change orders have been updated in our current report.

Background

Pursuant to the Educational Facilities Construction and Financing Act (the Act) enacted on July 18, 2000, the New Jersey Economic Development Authority (EDA) was authorized to undertake a comprehensive school construction and financing program which would include the funding, design, and construction of school facilities in Abbott districts (now SDA districts). Executive Order #24, issued on July 29, 2002, established the New Jersey Schools Construction Corporation (SCC), a subsidiary of the EDA, and charged it with the responsibility of fulfilling the Act's requirements.

On August 6, 2007, legislation was enacted which revised the school construction program established under the original act, abolished the SCC, and created the New Jersey Schools Development Authority (SDA), in but not of the Department of the Treasury. All functions, powers, duties, and employees of the SCC were transferred to the SDA. The SDA Board consists of the Commissioner of Education, the Commissioner of the Department of Community Affairs, the executive director of the Economic Development Authority, the State Treasurer, and eleven public members appointed by the Governor.

In order to finance the state share of costs for school facilities projects, the Act initially authorized the EDA to issue bonds with aggregate principal amounts not to exceed $6 billion for Abbott district projects, $2.5 billion for non-Abbott district projects, and $100 million for county vocational school district projects. In the summer of 2005, the SCC determined that sufficient funds were available to complete only 59 of 155 Abbott district projects that were in pre-construction. In April 2007, the SCC identified a structural deficit of approximately $600 million as a result of inaccurate project cost data, emergent projects, and higher inflation. As a result, the SCC developed a Capital Deferral Plan which funded 32 projects through completion and the remaining 27 through pre-construction.

On July 9, 2008, legislation was enacted authorizing the EDA to issue an additional $2.9 billion in bonds to finance the state share of SDA district projects, and $1 billion to finance the state share of all other district projects, of which $50 million is designated for county vocational school district projects. With the enactment of this legislation, the SDA developed the 2008 New Funding Allocation and Capital Plan for SDA Districts (the 2008 Strategic Plan). The plan's first priority was to fund the 27 deferred projects through completion at a total estimated cost of $971 million. Subsequently, two projects were combined, four project substitutions occurred, and two projects were suspended leaving 24 deferred projects currently in the plan. Prior investment in these 24 projects totaled approximately $89 million as of July 2008. Sunk costs for the six suspended or replaced projects totaled approximately $25 million as of February 28, 2010. This includes property acquisition costs of $9.4 million. Since program inception, an additional $57 million has been expended to acquire properties for other currently suspended projects. The 2008 Strategic Plan also provided funding for 26 new projects at an estimated cost of $1.7 billion. Subsequently, the SDA Board authorized two project substitutions. Sunk costs for the two replaced projects totaled $1.4 million.

Execution of the 2008 Strategic Plan is still in its early stages as the majority of the projects have not reached the construction phase. As such, the effectiveness of the SDA's budgetary process, including the percentage of any project cost overruns, cannot be evaluated at this time.

Strategic Plan

The strategic plan should prioritize and fund those schools most in need.

Pursuant to section 5 of the Educational Facilities Construction and Financing Act (the Act), the Commissioner of Education (the commissioner), in consultation with each SDA district, shall establish an educational priority ranking of all school facilities projects in the SDA district based upon critical need in accordance with priority project categories developed by the commissioner. The project categories shall include, but not be limited to, health and safety, overcrowding, and spaces necessary for disabled students, rehabilitation, and educational adequacy. Upon the establishment of the priority rankings, the SDA, in consultation with the commissioner, the SDA districts, and the municipalities in which the districts are located, shall establish a statewide strategic plan to sequence the school facilities projects based upon the projects' educational priority rankings and issues which impact the SDA's ability to complete the project.

Our review disclosed that the methodology utilized to establish the 2008 Strategic Plan did not fully comply with the Act's requirements resulting in less critical projects being funded. As previously mentioned, the initial 2008 Strategic Plan included funding for 27 projects that had previously been deferred due to a funding shortfall. These projects, however, were not included in the prioritization process required by the Act and may not have been the most critically needed since they were not compared to and ranked against all other proposed projects. In fact, as previously mentioned, several deferred projects have now been suspended or replaced by alternative projects deemed to have a greater need by the districts. Additionally, the 2008 Strategic Plan required every district except Neptune to receive at least one project which was not part of the Act's requirements. Neptune did not have any unfunded projects remaining.

Utilizing a ratings system that assigns points for various criteria, the commissioner ranked 42 of 117 projects identified by the SDA districts as priorities. The project with the highest point total was ranked number one and considered the most educationally needed and so on. All 42 ranked projects, however, could not be included in the 2008 Strategic Plan because the deferred projects were funded.

An overcrowding analysis comparing existing and projected enrollments to capacity was utilized as part of the criteria to rank the projects. A district's capacity includes projects in progress. Our review disclosed that Elizabeth had the largest projected deficit, approximately 2,800 seats for kindergarten through fifth grade classrooms (K-5). The district, however, did not receive any corresponding projects in the 2008 Strategic Plan even though a new proposed school serving grades two through eight was ranked number 26 by the commissioner. By comparison, a deferral project providing classrooms for pre-kindergarten through fifth grades in Long Branch is included in the 2008 Strategic Plan even though this district had a projected surplus of 667 seats in grades K-5. This project, which was the only one received by the district, also involves the demolition and replacement of a school that the former SCC paid over $3 million to renovate.

Temporary classroom units are utilized to alleviate overcrowding and should be a temporary fix not a permanent solution. Our review noted that Elizabeth has been utilizing 50 temporary classroom units for its preschool program since 2002. A district representative informed us that there is a waiting list of approximately 500 children for the preschool program. The district, however, did not receive any projects in the 2008 Strategic Plan to address this overcrowding issue. By comparison, a new early childhood center for Burlington City was funded in the 2008 Strategic Plan even though their preschool program had a projected deficit of only 57 seats and they do not utilize any temporary classroom units. This was the only project the district received as the commissioner's analysis did not identify overcrowding for any other grade levels.

Since program needs far exceed available state funding, it is imperative that the SDA districts with the most critical needs receive priority with respect to new schools. The methodology utilized to formulate the 2008 Strategic Plan was not completely effective in achieving this goal resulting in some less critical projects being funded.

Recommendation

We recommend the requirements set forth in the Act to prioritize and sequence SDA school facilities projects be strictly adhered to by the Board. All proposed projects including those previously suspended because of budget shortfalls should be included in the prioritization process to ensure current critical need and educational adequacy. In addition, the SDA, in consultation with the DOE, should consider revising the current Strategic Plan after incorporating any deferral projects that have not advanced past design into the project ranking process and eliminating the requirement that every district is to receive a project.

Change Orders

Controls over change orders need to be strengthened.

A change order is a written order directing or authorizing a change in the work to be performed by a contractor, stipulating any adjustments to compensation and time warranted by the change. The SDA categorizes its change orders into two main types: construction change orders and professional service amendments, which are changes to construction management, project management, and design consultant contracts.

There were 4,294 construction change orders totaling $113 million and 515 professional service amendments totaling $17 million executed during our audit period. Our review found the change orders were necessary and properly approved. However, current procedures are not adequate to ensure they are properly supported and processed in accordance with applicable policies and procedures. Our review of 25 construction change orders totaling $4.35 million and 22 professional service amendments totaling $6 million noted the following weaknesses.

- The SDA has established written policies and procedures for processing construction change orders. However, there are no policies and procedures for the review and processing of professional service amendments.

- We found 14 change orders totaling $3.8 million that were approved without sufficient documentation to support the change order's price, description, or cause. In addition, 23 change orders did not have all of the SDA-required forms in the change order file, and 20 of the 22 construction change orders tested did not have a written evaluation by the design consultant as required by contract. Processing change orders without adequate documentation could lead to the approval of unjustified change orders and the misappropriation of state funds.

- Despite contract language requiring change requests to include a "complete explanation" and a "detailed description" of the change, three construction change orders tested had scopes of work which were not clearly defined. Although we were able to establish the change was outside of the original contract's scope, we were unable to determine the extent of the work proposed in the change order.

The value of these change orders was $646,000.

- Independent cost estimates of change requests are critical for negotiating a fair and reasonable price. Only the contract for construction management requires a "detailed written estimate" be performed on change requests. Our review found four of eight construction change orders tested did not have an independent cost estimate as required by the contract. In addition, we found 13 of the remaining 39 change orders reviewed lacked a documented review of the change order's cost.

- Twenty-two of 41 change orders tested totaling $4.6 million had no record of negotiations in the change order file. Documenting the resolution of any differences between the contractor's price proposal and the price paid helps establish negotiations were in good faith and minimizes disputes over what work was agreed-upon.

- The amount of time it takes for change orders to be approved is excessive. Construction change orders had an average of 178 days between the contractor's proposal and the SDA's final approval. The average was 127 days for professional service amendments. Prompt approval of change orders keeps the project moving and helps to maintain a positive relationship between the SDA and its contractors.

Recommendation

We recommend the SDA enforce existing construction change order policies, procedures, and contract provisions and develop written policies and procedures for the review and processing of professional service amendments to help ensure change order files include appropriate supporting documentation. Change orders should be processed more timely. The SDA should also develop, either internally or by its consultants, independent cost estimates for all change requests. In addition, the SDA should provide training to help ensure compliance with the above matters.

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June 8, 2010

Mr. Stephen M. Eells
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Dear Mr. Eells:

Management of the New Jersey Schools Development Authority ("the SDA" or "the Authority") has reviewed the audit report prepared by the State Auditor relative to certain operations of the SDA during the period July 1, 2007 to February 28, 2010. The SDA appreciates the opportunity to comment on the State Auditor's findings, observations and recommendations.

As an opening observation, the SDA is pleased with the State Auditor's conclusion in this audit report that the Authority has resolved most of the significant issues that were identified in the State Auditor's comprehensive 2006 report. Since the issuance of the 2006 report, significant processes and controls have been put in place at the Authority in response to the recommendations made. The SDA is pleased that these changes have resulted in recognized process improvements. On that note, the SDA also agrees with the State Auditor's recommendations relative to the processing of change orders and is committed to ongoing improvement efforts relative thereto.

There is one area in the State Auditor's report that SDA Management wishes to add context through this response. In its report, the State Auditor concludes that "some of the projects included in the 2008 Strategic Plan may not have been the most critically needed since they were not subject to the prioritization process mandated by law." The report goes further to provide that "[t]he methodology utilized to establish the 2008 Strategic Plan did not fully comply with the [Educational Facilities Construction and Financing Act's] requirements." As discussed with the State Auditor during its review and preparation of the report, SDA Management prepared the 2008 Strategic Plan in accordance with express guidance from the administration, while remaining true to the spirit of the Educational Facilities Construction and Financing Act ("the Act").

Following the issuance of the Inspector General's report pertaining to the Schools Construction Corporation ("the SCC") in 2005, Governor Jon Corzine issued Executive Order No. 3 which established an Interagency Working Group for School Construction ("Working Group") charged with performing a full review of the SCC. The Working Group subsequently issued three Reports to the Governor (issuance dates of March 15, May 17 and September 14, 2006) that collectively recommended major operational and programmatic changes to move the State's school construction program forward. Among the Working Group recommendations were some focusing on additional funding and the future of projects in the then current capital plan.

In reaching its recommendations in the first Report, the Working Group assumed that any new funding authorized by the legislature would go first to finish projects in the then-current capital plan. Specifically, the Working Group recommended that the Department of Education and the SCC "work to develop a process for prioritizing the implementation of the remaining projects in the capital plan" as well as a strategy which anticipated how these projects would be ordered if additional funding was forthcoming. This assumption recognized the State's prior obligations with respect to the projects in the then-current capital plan, and incorporated the idea that the State would use any new funding to satisfy those obligations before deciding how to rank remaining projects that were not a part of the capital plan at that time. Likewise, in recommending the pursuit of $2.5 billion in new funding in the third Report, the Working Group stated that "[t]his funding level will provide resources to complete the projects that were previously authorized as part of the current 2005 Capital Plan, provide for the establishment of a reserve fund...and provide much needed resources to reactivate many of the projects that had been suspended."

Not only did the 2008 Capital Plan incorporate the recommendations of the Working Group, but the 2008 amendments to the Act authorizing additional funding also relied in part upon recommendations offered in the Working Group Reports. Both the Act and the Working Group recommendations provided the framework for the 2008 Capital Plan. The Working Group recommendations served to inform the first articulated goal of the 2008 New Funding Allocation and Capital Plan: to complete the 2007 Deferral Plan phase funded projects (2008 New Funding Allocation and Capital Plan for SDA Districts, adopted by the SDA Board July 8, 2008). With that goal identified as an important priority for the 2008 Capital Plan, the SDA included those 27 identified deferral projects as prior obligations of the state. The 2008 Capital Plan then applied a methodology for identification and inclusion of new projects using educational assessment as the first criteria. The State Auditor's findings do not criticize the methodology as applied to those new projects and their inclusion in the 2008 Capital Plan.

While the above provides background context for the creation of the 2008 Capital Plan, SDA management remains committed to ensuring that the most critical projects across the state advance. The SDA acknowledges that school districts' comparative needs may shift with the passage of time, and, therefore in part, the SDA is pursuing an updated review of the 2008 Capital Plan. As part of this process, the SDA will consider the findings and recommendations set forth in the State Auditor's Report as it seeks to ensure the advancement of the most appropriate projects while recognizing the greatest need and exercising fiscal responsibility.

Very truly yours,

Marc D. Larkins
Chief Executive Officer