LEGISLATIVE EDUCATION STUDY COMMITTEE
BILL ANALYSIS
53rd Legislature, 1st Session, 2017

Bill Number HB140 **Sponsor** Representative Ely

Tracking Number .205379.2SA **Committee Referrals** HTPWC/HTRC

Short Title Capital Outlay Project Audits

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BILL SUMMARY

Synopsis of Bill

House Bill 140 (HB140) requires any entity that is the fiscal agent for a capital outlay project receiving more than $1 million in state funding pay for a special audit to ensure funds were used properly. The audit will be subject to the provisions of the Audit Act.

FISCAL IMPACT

HB140 does not contain an appropriation; however, it will have a fiscal impact. HB140 proposes the entity serving as fiscal agent for the capital outlay project pay the cost of a special audit to be conducted by an independent auditor approved by the state auditor. If the fiscal agent is a state agency overseeing an appropriation for a state-owned facility or the fiscal agent is an eligible subdivision of the state (such as a school) the cost of contracting an independent auditor could have a substantial impact on the entity's operating budget.

According to the Office of the State Auditor (OSA), although difficult to estimate with precision, the OSA anticipates special audits at the conclusion of capital outlay projects would yield net savings. The requirement of a special audit could help set the tone of projects by establishing oversight, and could result in increased savings through cost avoidance and recovery of overspent or misspent funds.

The OSA estimates the cost of a capital outlay project audit to be $10 thousand or less, depending on the project and quality of associated documentation. The OSA stated the required procedures would be less cumbersome than an annual audit. A capital outlay project audit involves a routine set of procedures that looks at documentation and other audit support for money spent and works completed, and evaluates basic compliance issues. The OSA noted the fiscal implications of this bill would be delayed, because only projects commencing in FY18 or later would be subject to HB140, and those projects would not be complete until FY19 or later. In addition, audit costs would be spread out among agencies that complete capital outlay projects.

This analysis only considers the impact on public schools. For all Public School Capital Outlay Council (PSCOC) awarded projects greater than $1 million, capital outlay special audits may either be funded from the Public School Facilities Authority (PSFA) operational budget, or could be incorporated into each project budget, which would increase project costs.

Based upon all active PSCOC awards, PSFA has 34 projects totaling over $419 million. PSFA estimations are as follows: projects less than $4 million in state funds would require approximately 40 audit hours, projects less than $30 million would require approximately 100 audit hours, and projects greater than $30 million would require approximately 140 audit hours. The estimated hourly rate for special audits ranges between $90/hour to $130/hour. Thus, PSFA analysis used an average rate of $110/hour plus applicable gross receipts tax (GRT). The fiscal impact for all active PSCOC awards would be $545,362 as illustrated in Attachment A.

According to the PSFA, the fiscal impact to the PSFA is dependent upon the amount of awards made by the PSCOC to school districts. The primary source of funding for the public school capital outlay fund is the issuance of supplemental severance tax bonds (SSTBs). Public school capital outlay fund revenue forecasts have declined due to the decrease in oil and gas revenues, as illustrated below. Numbers have been rounded.

Projected Revenue Estimates for the Public School Capital Outlay Fund (dollars in thousands)

	FY17	FY18	FY19	FY20	FY21	Total
SSTBs August FY16 Estimate	$120.4	$120.6	$125.4	$142.3	$127.2	$636.0
SSTBs December FY16 Estimate	$112.0	$110.0	$123.8	$122.7	$120.6	$589.1
Decrease	-$8.5	-$10.6	-$1.7	-$19.6	-$6.6	-$47.0
Percent Change	-7.0%	-8.8%	-1.3%	-13.8%	-5.2%	-7.4%

Source: PSFA

The PSFA operational budget is statutorily limited by section 22-24-4 NMSA 1978 to 5 percent of the average annual grant assistance authorized from the fund during the three previous fiscal years. Revenue forecast reductions will reduce the amount available for budget operations. PSFA is currently recognizing a potential budget reduction for FY18 estimated between 5.5 and 6.5 percent. Projected additional audit expenditures are not budgeted in FY18 and cannot be easily absorbed in the operational budget without major modifications.

Current PSFA staff conducts internal audits of all projects.

SUBSTANTIVE ISSUES

HB140 adds a new section to the Audit Act, Section 12-6 NMSA 1978, requiring every capital outlay project receiving over $1 million from the state to have a special audit at the end of the project. This audit would be separate from the annual audit and any other audits required by the state auditor. The audit would verify all funds were used properly and in accordance with state law and local ordinances. HB140 requires the entity serving as the fiscal agent for the capital outlay project to pay for the audit, which must be conducted by independent auditors approved by the state auditor. The capital outlay project audit will be subject to the Audit Act. The effective date of these provisions is July 1, 2017.

The OSA will oversee implementation of HB140.

ADMINISTRATIVE IMPLICATIONS

HB140 may be challenging for agencies to implement under current staffing levels and could impose an unfunded financial burden. Agency staff members who work on capital outlay can expect to be involved in the audit, to provide a history of the project, the roles and responsibilities of the project team, and project risks. Project team members, such as the project manager, purchasing, contracting, and finance, can expect to answer questions about existing policies and procedures, gaps and challenges, project cost and schedule status, lessons learned, successes and failures.

According to the Higher Education Department (HED), which currently has 19 capital outlay projects exceeding $1 million, HB140 would cause undue hardship on current staff given existing staffing levels. According to HED, they only have one full-time staff member who handles capital outlay. Currently, HED follows Executive Order 2013-006 which establishes uniform funding criteria, grant management, and oversight requirements for state capital outlay appropriations by state agencies to other entities. Executive Order 2013-006 requires state agencies to ensure state capital outlay appropriations are approved in accordance to law; utilize the appropriate capital outlay grant agreement template developed by the Department of Finance and Administration (DFA); and conduct field audits of capital outlay projects in accordance with policies and procedures prescribed by the DFA. HED noted the time and effort required to implement HB140 added to the requirements of Executive Order 2013-006 would cause undue hardship on staff.

The New Mexico Department of Environment (NMED) stated HB140 would create an administrate burden on the agency. According to NMED, some projects receive capital outlay funding over multiple years or from multiple state funding sources that total $1 million. If capital outlay funding totaling $1 million is allocated to different agencies, NMED stated it may be difficult to determine who would be responsible for the special audit.

OTHER SIGNIFICANT ISSUES

Audits are a way to ensure transparency and accountability in large government projects. The Government Finance Officers Association recommended in 2009 that jurisdictions establish policies and processes for capital outlay project reporting. Additionally, the Association of Local Government Auditors endorsed capital outlay project audits as a means of controlling costs and increasing efficiency. The Journal of Cost Engineering identified the most common capital outlay project audit findings and the areas of risk they can help to mitigate; this information can be found on Attachment B.

The Association of Local Government Auditors identifies the following risks a capital outlay project can address:

- Improper, inefficient, inappropriate expenditure of funds;
- inadequately financed projects;
- untimely completion;
- inadequate contract provisions, such as scope of work or change order procedures;
- funds not expended in compliance with governing laws and regulations or contractual provisions;
- questionable change orders;
- inadequate monitoring and oversight by staff;
- improper selection criteria for contractors.

Capital outlay project audits can improve the long-term performance of government agencies overseeing these projects by giving them insight into weaknesses in internal controls and processes. In addition, these audits may give agencies an opportunity to correct deficiencies before they become an issue.

ALTERNATIVES

The Legislative Finance Committee noted: "similar legislation proposed in past years requiring an audit of capital outlay projects suggested using a percentage of the appropriated amount to be allowed for use by the fiscal agent to conduct an audit upon completion of a project. Currently, the State of New Mexico is required to comply with Internal Revenue Service regulations pertaining to the issuance and use of tax-exempt severance tax bonds. While the state does not currently require special audits of capital outlay projects, the State Board of Finance does closely scrutinize the use of bonds for capital projects."

RELATED BILLS

Related to HB149, *Crime of Audit Obstruction*, a bill adding a criminal offense provision for obstruction of any state audit to the Audit Act.

SOURCES OF INFORMATION

- LESC Files
- Higher Education Department (HED)
- Office of the State Auditor (OSA)
- Public School Facilities Authority (PSFA)
- Department of Environment (NMED)

MCR/rab

PSFA Estimates of Special Audit Fees for Active PSCOC projects

School District	Project Name	State Award Amount	# of Audit Hours	Hourly Rate	Subtotal	NMGRT @ 7.3125%	Total
Deming	P07-005 Deming High School	$56,300,000	140	$110	$15,400	$1,126	$16,526
Farmington	P13-006 Farmington High School	$40,921,113	140	$110	$15,400	$1,126	$16,526
Zuni	P13-010 Zuni ES (Shiwi T'sana)	$29,210,359	100	$110	$11,000	$804	$11,804
Gadsden	P14-011 New Elementary School (Gadsden)	$19,458,356	100	$110	$11,000	$804	$11,804
Bernalillo	P12-005 Bernalillo High School	$19,360,000	100	$110	$11,000	$804	$11,804
Gallup-McKinley	P11-005 Del Norte ES (Washington)	$18,710,196	100	$110	$11,000	$804	$11,804
Gallup-McKinley	P15-007 New Lincoln ES (New Combined ES -Gallup)	$18,328,259	100	$110	$11,000	$804	$11,804
Las Cruces	P11-011C - Las Cruces High School Phase II	$17,531,328	100	$110	$11,000	$804	$11,804
Grants-Cibola	P14-014 Los Alamitos MS	$16,206,000	100	$110	$11,000	$804	$11,804
Central	P14-007 Grace B Wilson ES & Ruth N Bond ES	$15,250,000	100	$110	$11,000	$804	$11,804
Deming	P14-008 Deming Intermediate School	$14,868,487	100	$110	$11,000	$804	$11,804
Lordsburg	P14-017 Lordsburg HS	$14,443,685	100	$110	$11,000	$804	$11,804
Reserve	P14-022 Reserve Combined School	$14,256,519	100	$110	$11,000	$804	$11,804
Gadsden	P08-003D (Phase 3 Part 3) Gadsden High School	$13,667,357	100	$110	$11,000	$804	$11,804
Gadsden	P14-012 Chaparral ES	$12,828,187	100	$110	$11,000	$804	$11,804
Albuquerque	P14-001 Albuquerque Marie Hughes ES	$10,815,434	100	$110	$11,000	$804	$11,804
Roswell	P14-023 Parkview Early Literacy	$9,802,699	100	$110	$11,000	$804	$11,804
Gallup-McKinley	P14-013 Ramah ES	$9,490,028	100	$110	$11,000	$804	$11,804
Mountainair	P15-008 Mountainair Jr/Sr HS	$9,124,126	100	$110	$11,000	$804	$11,804
Bernalillo	P13-002 Santo Domingo Elementary/Middle School	$8,659,774	100	$110	$11,000	$804	$11,804
Albuquerque	P15-002 Mountain View ES	$6,865,120	100	$110	$11,000	$804	$11,804
West Las Vegas	P13-009 West Las Vegas Middle School	$6,717,738	100	$110	$11,000	$804	$11,804
Albuquerque	P14-004 Atrisco ES	$5,967,243	100	$110	$11,000	$804	$11,804
NMSD	P13-008 NMSD Santa Fe	$5,849,019	100	$110	$11,000	$804	$11,804
Mesa Vista	P14-018 Ojo Caliente ES	$5,339,034	100	$110	$11,000	$804	$11,804
NMSBVI	P14-021 Recreation / Ditzler Auditorium	$4,937,393	100	$110	$11,000	$804	$11,804
Socorro	P12-011 San Antonio Elementary School	$4,739,737	100	$110	$11,000	$804	$11,804
NMSBVI	P13-015 NMSBVI Site Improvements	$2,972,360	40	$110	$4,400	$322	$4,722
Clovis	P15-005 Parkview ES	$2,024,648	40	$110	$4,400	$322	$4,722
Gallup-McKinley	P15-006 Thoreau ES	$1,516,391	40	$110	$4,400	$322	$4,722
Alamogordo	P15-001 - Combined ES (Alamogordo)	$1,301,852	40	$110	$4,400	$322	$4,722
Clovis	R15-001 Cameo Elementary School Entire Building	$1,038,548	40	$110	$4,400	$322	$4,722
Belen	P14-005 Rio Grande ES	$1,004,271	40	$110	$4,400	$322	$4,722
	Total	$419,505,261			$332,200	$24,292	$356,492

Source: PSFA

Audit Issue	Risk
Construction program was started before budget and schedule were finalized.	Lack of expenditure controls at the start of the project.
Construction program scope clearly exceeds the available funds.	Accountability to voters or funding source, possible legal implications, facilities needs not met.
Funding for construction program was obtained from several different sources.	Failure to accurately track expenditures against funding source, difficulty in identifying key schedule milestones for funding requests.
Failure to review payment applications and invoices against contract provisions.	Potential overpayment with respect to hourly rates, quantities, reimbursable expenses, scope, and schedule.
Change orders are calculated using unit rates higher than those included in the contract.	Potential overpayment with respect to hourly rates, quantities, reimbursable expenses, scope, and schedule.
Failure to require justification for contingency and allowance expenditures.	Hidden profit.
Failure to require justification for reimbursable expenditures.	Hidden increase to the contractor’s fee.
General requirements are included in the schedule of values as direct costs, upon which general conditions and fee are added.	Potential overpayment of general conditions items, and hidden increase to the contractor’s fee.
Retention is not held consistently on subcontracts.	No financial recourse available for subcontractor nonperformance.
Program manager time is allocated between projects on a percentage basis, not on actual time incurred.	Understatement / overstatement of actual project costs, lack of an appropriate time reporting system. Potential overpayment for equipment.
Monthly equipment charge over the course of the project exceeds the Fair Market Value for the equipment.	Potential overpayment for equipment.
Equipment is charged to several projects, instead of being allocated on a percentage basis.	Lack of policies and procedures for the new system, possible failure to capture expenditures, incorrect cost reporting.

Source: Journal of Cost Engineering