

# Bond best practices

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## Pros advice on how to avoid pitfalls when spending bond bucks

*By Craig W. Anderson*

Last spring, executives from a construction firm that manufactured and installed prefabricated school buildings statewide pleaded no contest to charges they had stolen \$3.6 million in construction funds from a California school district. The executives will be spending time in state prison for their misdeeds.

Is this an isolated incident or are school districts across the state vulnerable to construction project fraud?

Experts say school districts are susceptible to deceit due to the large workforce utilized for district projects: architects, construction management companies, multiple contractors and sub-contractors, and a variety of district employees, any one of which could commit fraud.

The construction industry is under pressure because the economic recession has reduced profit margins for construction companies, and this translates to pressure on the bottom line and an incentive to commit fraud.

A primary concept in the world of scams is the Fraud Triangle and, according to fraud investigator Jenny Dominguez, CPA, Certified Fraud Examiner (CFE) and Certified in Financial Forensics (CFF), it has three elements: financial stress creating an urgent need for money, rationalization that justifies fraudulent behavior, and opportunity in a situation lacking proper checks and balances to prevent fraud.

Dominguez, senior manager for CASBO associate member Vicenti, Lloyd & Stutzman's Fraud Solutions Unit, said, "While school districts can't resolve the three elements of the triangle, they can reduce the opportunity for fraud with improved oversight and strong internal controls throughout the project."

She said that Proposition 39, passed in 2000, caused a construction boom in California by allowing the easier passage of construction bonds, with many schools acquiring bond money, thereby providing incentive for fraud.

According to a report from the Association of Certified Fraud Examiners, fraud in the education industry has an average median loss of \$36,000. "I've worked on cases with losses from \$30,000 to \$40,000 to nearly \$1 million," Dominguez said. "Fraud is insidious and expensive."

She said school districts continue to be vulnerable because the level of construction has increased over the last decade and the level of funding "is new to most individuals at school districts. They may not have had as high a level of funds and construction in decades, or it's their first time."

Dominguez pointed out that school districts are no more at risk than any other organization for fraud, but that it can cause safety problems for students, teachers and administrators if it affects school construction.

School districts can reduce their vulnerability to fraud significantly during construction with proper oversight and strong internal controls.

"District management must directly monitor the budget, change orders and the quantity/quality of goods and materials received by assigning a competent, experienced individual to the oversight of the construction process," Dominguez said.

"There are lots of red flags, depending on the phase of the project," she said. "An indication of fraud is a significant amount of change orders which could mean kickbacks with a district employee."

A change order is a document that describes changes in the project and the higher costs for those changes; it comes from one of the entities involved in the construction and essentially asks for more money.

Project oversight can be augmented by an outside inspector such as a Division of the State Architect (DSA) inspector, certified through the state, who will be on-site full time to help the district ensure everything is above board.

"The school district's project could be as little as a couple of portables or so large that you might be on the job for years," said Scott Saddlemire, a DSA inspector and president of Superior Construction Services Inc., in Upland. "But we average about a year per job.

"The change order provides the biggest opportunity for fraud and it could be from the facility manager, contractor, architect or the construction manager," Saddlemire said.

It is important to have the proper segregation of duties so no single individual is responsible for choosing vendors/contractors, preparing invoices or recording expenses.

Dominguez had a positive viewpoint about school districts being prepared. "I'd estimate 75 percent of school districts have the necessary individual in place to provide oversight."

### **An avenue for whistle blowers**

"I suggest establishing an avenue to report fraud so anyone can anonymously report fraud," Saddlemire said. A typical fraudster is a long-term, high-level, trusted employee, and if a lower-rank employee suspects fraud, an anonymous tip line makes it more likely that unethical behavior will be reported without fear of retaliation.

Regarding kickbacks, an anonymous tip is crucial, he said, because "kickbacks seldom leave an audit trail and can be hard to find and hard to prove, which makes the hotline an indispensable fraud prevention tool."

Tip lines are effective, according to a report from the Association of Certified Fraud Examiners that states anonymous tips are the No.1 way fraud is detected.

Saddlemire said it's good policy to create a fraud hot line and to publicize it to all contractors, vendors and district employees who are part of, or witness to, the construction process.

### **Create a budget**

Lacking a formal, vetted and approved budget creates great risk to the district. Time and dollar budgets provide a baseline expectation for cost and duration, the spur to identify available resources to fund/complete the project, and a reporting mechanism to the board of trustees.

Costs that exceed the budget should be investigated and understood. "Verifying that increases are in line with industry changes could prevent overpaying by the district," Dominguez said.

It may be appropriate for a district to hire an outside professional construction management company to help develop a budget, Saddlemire said. "They have access to monthly publications of construction data listing the current market value of every aspect of a construction project, including prevailing wages and materials costs."

A construction manager can use this information to check the authenticity of change orders and to catch any suspicious elements.

Why use an outside construction management company and its management personnel?

“It’s an external, objective entity in the project,” said Saddlemire. “Their fees aren’t based on the size or scope of the project, so they have nothing to gain by inflating materials costs.”

“A lot of school districts use construction management services,” said Jordi Rodriguez, project director for CASBO associate member Vanir Construction Management in Sacramento, “brought in at the very beginning to help district staff manage construction, planning, design process management and whatever the project requires.”

### **Front-end documents**

Saddlemire recommends building into the specification documents as much detailed information as possible to eliminate any confusion about size, quantity and technique because, he said, “The stronger the specifications, the better. You want a document with some teeth in it if a contractor tries to justify inappropriate change orders.” He also said to review the specifications with the district counsel to ensure the language can stand up to scrutiny.

Contractors take on the risk that material and labor costs will fluctuate frequently and rapidly and “ethical contractors accept that risk and the losses it may bring,” he said. “However, fraud can take place when a contractor tries to recoup losses by increasing fees or decreasing quality.”

### **Pre-qualification and post-bidding conferences**

The construction sector is suffering from reduced profits, and school construction is experiencing increasing numbers of small contractors bidding for work. The school district can ensure that bids come from qualified bidders by using specific language in the front-end documents that describe the experience needed. This allows districts to legally exclude under-qualified bidders.

The district can then hold a post-bidding conference with the chosen bidder to guarantee that the contractor’s responsibilities are clearly outlined.

“The post-bidding conference is a great way to make sure that everyone is on the same page,” noted Saddlemire. “Before signing the contract, go over the scope of the project and if the contractor is in over his head, he has an out.”

### **Set policies for change orders**

Change orders are created when there is a change in the project requested by the district, or when an unforeseen circumstance alters things.

However, change orders can't be written for increased cost due to market swings and "change order policies protect the district from overpaying contracted amounts," Dominguez said.

Policies need to be in place that determine how change orders can be submitted and approved, and by whom. This could include dollar thresholds or signature requirements that trigger approval or more investigation.

Monitoring of deliveries of goods and materials and creating an internal audit function are additional ways to prevent fraud.

### **Bond issues**

As if fraud wasn't threat enough, some school districts are being excoriated for using borrow now, pay later capital appreciation bonds (CAB).

School districts that passed bond issues in June are now spending the funds on new construction and facility upgrades, but if a cab is the funding source, trouble could be on the way, as the Poway Unified School District discovered.

The district obtained \$105 million for school construction, repaying \$981 million via the long-term financing of a CAB. The district cannot pay anything on the bond for 20 years, while interest compounds and repayment takes place over the final 20 years, fulfilling the maximum 40-year term per state law.

A number of other districts statewide have also captured the media and the public's attention lately due to their use of cabs.

Ruth Alahydoian, vice president at KNN Public Finance in Oakland and a CASBO member, said, "Issues with cabs come from abuse of the process, not because of fraud. This type of bond is a tool, but the 40-year piece of it makes it unpalatable.

"CABs are more complicated and not for the average investor, but for more sophisticated investors," Alahydoian said. "School districts should do nothing school boards can't understand. They're not something that can be explained late in school board meetings."

The economic downturn has changed California school bond financing, Alahydroian said. “These bond financings included bond structures that defer debt service to future years, along with repayment terms of up to 40 years.”

Many county treasurers are concerned about practices they see in school district bond issuers and have cautioned school districts against the use of CABs.

“The critics are correct in pointing out practices of concern, including high debt service obligations over time, lack of flexibility and need for more robust communication process,” Alahydroian said. “A better communication process would help convey the often complicated decisions surrounding the bond program.”

CABs have generated such malaise that Assembly Member Ben Hueso, a democrat from Chula Vista, intends to introduce legislation that will curtail the use of cabs by school districts and community college districts.

Alahydroian said that most districts now try to limit issuance of cabs and that school boards “must make every effort to ensure that they, the public and the superintendent understand all aspects of CABs.”

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