



## **Seattle Public Schools The Office of Internal Audit**

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### **Capital Internal Audit Report Fairmount Park Elementary School Construction**

Issue Date: December 16, 2014



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### Executive Summary

#### Background

In accordance with the *Capital Risk Assessment and Audit Plan* approved by the Audit and Finance Committee on April 10, 2014, we have completed a construction audit of the Fairmount Park Elementary School Renovation and Addition project. Capital internal audits are designed to accomplish the following:

- Review construction activity, with a focus on high-risk aspects.
- Examine the processes, activities, and transactions that impact Capital Projects Fund resources.
- Provide the district with value-added recommendations to improve internal controls, mitigate risks, and increase compliance.

Fairmount Park was originally constructed in 1964, closed in 2007, and has reopened to manage the growing capacity needs in West Seattle. The scope of the project includes renovation of two existing buildings; construction of a 12-classroom, 2-story addition; construction of a new on-site bus loading area; and demolition of two portable classrooms and a portion of the existing principal structure. The construction budget was approximately \$11 million. There were 14 change orders totaling \$1.5 million, 77 days were added to the schedule, and the project reached substantial completion on August 12, 2014. Forty-nine percent of changes were district directed; 34 percent were due to unforeseen conditions; 11 percent resulted from errors and omissions; 6 percent were required by authorities with jurisdiction.

#### Audit Scope and Objectives

The focus of the audit was the Fairmount Park Elementary School renovation and construction project. We used the project's change orders to evaluate the district's overall processing of construction change orders. The audit does not review all project activity or address all project risks. The primary objective of the audit was to determine whether internal controls over the change order process, including procedures for managing project contingency, are effective and working as intended.

As this is the first in a series of capital audits to be conducted, this audit included secondary objectives designed to ensure upcoming audits can be effectively performed. Therefore, this report contains recommendations that apply to all the district's construction projects. The secondary audit objectives were as follows:

- To determine whether the district's construction contract provisions allow for effective future audits.
- To determine whether the district has incorporated the most recent changes to public contracting statutes into its procedures, practices, and bid documents.



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### Audit Approach and Methodology

To accomplish the audit objectives, we performed the following procedures:

- Examined the Fairmount Park contracting files and project delivery manual to plan the audit, identify business risks associated with the project, and ascertain the district's compliance with recent changes to public contracting laws.
- Gained an understanding of the process the district uses to initiate, review, approve, and execute change orders.
- Reviewed change order policies and procedures.
- Interviewed staff responsible for the processing of change orders.
- Interviewed personnel from Contracting Services, Procurement, and Risk Management.
- Identified best practices for project contingency use and monitoring.
- Evaluated the overall effectiveness of internal controls over change order processing.
- Tested the universe of Fairmount Park change orders to determine if district procedures were followed and whether the process was consistent with the contract's general conditions.

### Conclusion

During audit planning and risk assessing, we discovered that the district can better protect itself from potential liability as it pertains to construction projects. The district should ensure its interests are protected under the contractor's liability insurance policy by insisting on additional insured endorsements.

Based on the results of our audit procedures, the district's internal controls over the change order process are working as intended. However, the district could improve the oversight of the project contingencies.

Except for the audit clause, we believe that the current construction contract provisions will allow the Office of Internal Audit to perform value-added construction audits. We found that the district has incorporated the latest changes to public contracting statutes into its contracts, procedures, and practices.

This report contains recommendations to enhance internal controls and mitigate risks to the district. We appreciate the assistance provided to us throughout the audit by staff from Capital, Legal, Finance, Accounting, Procurement, Contracting Services, and Risk Management.

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### Findings and Recommendations

#### 1) Change Order Process

Change orders occur when the district modifies the contract sum or revises the substantial completion date due to changes in the scope of work. Change orders can be the result of unforeseen site conditions, district requests, errors or omissions in design, regulatory changes, value engineering, or contractor actions, among other reasons. Before a change order is approved and use of the project contingency can be authorized, details of the changes, cost proposals, and other supporting documentation must be reviewed and approved by the appropriate district staff based on the dollar thresholds established in Procedure 6220SP.A. The change order process also includes a verification of budget availability and certification by approvers that district policies and legal requirements have been followed.

Project managers maintain a change order log that reflects the cost of all approved change orders as well as the estimated cost of changes that have been authorized but not yet approved through a formal change order. These *incurred* obligations generally originate from change directives, which authorize the contractor to perform additional work even though the parties may still be negotiating the final price and/or time adjustment. They are generally issued to prevent schedule delays. Because these costs are pending, they are not reflected in the accounting system when the Accounting Department checks for funds availability.

These procedures reflect the current process for authorizing and approving change orders. The district has begun using e-Builder project management software, which has budget management and cost control features. It is expected to enhance change order processing and interface with the district's accounting system. However, e-Builder is not fully implemented at this time. Therefore the district should improve its existing process, and Internal Audit will evaluate the impact of e-Builder on internal controls when appropriate.

#### Recommendation

The district could improve the monitoring of contingency funds and the visibility of contingency use by including the cost of pending obligations from change directives with the change orders submitted for review and approval. Proper contingency tracking is essential to controlling costs, preventing budget overruns, and establishing a detailed trail for audits or potential claims. This would serve the same internal control purpose as a contingency log and would accurately convey the status of the contingency allowance without revealing the amount remaining available.



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### **2) Contractor Insurance Coverage**

The district requires the construction contractor to maintain liability and builder's risk insurance at all times. A certificate of liability insurance with an additional insured endorsement is to be provided to the district before work commences and 45 days prior to renewal, termination, cancellation, expiration, or alteration of the policy. However, the district does not demand that the contractor include the endorsement with the certificate. A certificate without the endorsement does not amend the insurance policy to protect the district. In addition, the district has no procedures to ensure it obtains new certificates and endorsements when coverage expires.

### **Recommendation**

For liability insurance, we recommend Contracting Services obtain an additional insured endorsement in addition to a certificate of insurance, prior to execution of the contract. We recommend the project manager monitor the policy expiration date and obtain renewal certificates with endorsements throughout the project and for one year after the contractor's obligations have been fully performed. For builder's risk insurance, we recommend the project manager request renewal certificates until the work has been accepted by the district.



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### 3) Right to Audit Clause

Article 7 of the boilerplate general conditions allows the district the right to access and audit the contractor's records in order to substantiate changes to the contract and claims. The general conditions do not specify a time frame under which the district may exercise its audit rights. The right to audit provision should allow the district to examine any records necessary to evaluate the contractor's entitlement to payment under the contract and should state how long the contractor is required to make its records available for audit.

#### **Recommendation**

We recommend the district ensure the right to audit clause is sufficient to allow the district to examine any of the contractor's or subcontractors' records that pertain to their entitlement to payment under the contract or subcontracts. We recommend the district have the right to audit throughout the term of the contract and for at least one year after final payment. Legal should review and approve any changes to the contract language.



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### Management Response

#### Capital

*We concur with the findings and will implement these recommendations.*

#### Legal

*We concur and will incorporate these changes.*

#### Contracting Services

*Based on our discussions, we are updating our information that goes out to the awarded vendors to include the request for the endorsements with their certificates of insurance.*