PERFORMANCE AUDIT
OF THE

UNIVERSITY HOUSE PROJECT

EASTERN MICHIGAN UNIVERSITY

July 2004

33-608-04L

"…The auditor general shall conduct post audits of financial transactions and accounts of the state and of all branches, departments, offices, boards, commissions, agencies, authorities and institutions of the state established by this constitution or by law, and performance post audits thereof."

– Article IV, Section 53 of the Michigan Constitution

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REPORT SUMMARY

Performance Audit

University House Project

Eastern Michigan University

Report Number:
33-608-04L

Released:
July 2004

In June 2001, the Eastern Michigan University Board of Regents approved the construction of the University House as a $3.5 million project. The University intended for the 10,000-square-foot multipurpose facility to showcase the University's research and scholarship activities, to host fund-raising events, and to house visiting scholars and dignitaries, as well as to serve as the official residence of the University President.

Audit Objective and Conclusion:
To identify, by source, the total amount of funding for the University House project.

As of December 2003, funding included $229,500 in gifts and pledges, $347,407 transferred from the auxiliary fund to the plant fund, and $1,000,000 of future corporate royalties revenue. The source of remaining funding was the University's operating revenues. (Exhibit 1)

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Audit Objective and Conclusion:
To determine total expenditures related to the University House project.

Total direct expenditures as of December 2003 were $5.3 million. Total other costs associated with the University House project were an additional $0.7 million.

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Audit Objective and Conclusion:
To determine if operating revenues were used in funding the University House project.

Operating revenues were used in the University House project. We noted one material condition. The University used operating revenues to fund the University House project without obtaining approval from the Department of Management and Budget and the Joint Capital Outlay Subcommittee (Finding 1).

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Audit Objective and Conclusion:
To determine if the University House project funding and expenditures were accounted for in accordance with applicable statutes.

The University House project funding and expenditures were not accounted for in accordance with applicable statutes. We noted two material conditions. The University did not maintain sufficient budgetary control over the University House project expenditures (Finding 2). Also, the University did not comply with annual capital outlay appropriations acts with respect to the University House capital outlay project (Finding 3).

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Audit Objective and Conclusion:
To determine if the University maintained sufficient management control over the University House project.

The University did not maintain sufficient management control over the University House project. In addition to the material conditions related to project financing, budgetary control, and the use and financing statement (Findings 1 through 3), we also noted a reportable condition related to the University's contract bidding process (Finding 4).

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Agency Response:
Our audit report contains 4 recommendations. The University's preliminary response indicated that it agrees with all 4 recommendations.

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A copy of the full report can be obtained by calling 517.334.8050 or by visiting our Web site at: http://audgen.michigan.gov

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July 13, 2004

Mr. Philip A. Incarnati, Chair
Board of Regents
and
Samuel A. Kirkpatrick, Ph.D., President
Eastern Michigan University
Ypsilanti, Michigan

Dear Mr. Incarnati and Dr. Kirkpatrick:

This is our report on the performance audit of the University House Project, Eastern Michigan University.

This report contains our report summary; description of University House project; audit objectives, scope, and methodology and agency responses; background; comments, findings, recommendations, and agency preliminary responses; exhibits, presented as supplemental information, and a glossary of acronyms and terms.

Our comments, findings, and recommendations are organized by audit objective. The agency preliminary responses were taken from the University's responses subsequent to our audit fieldwork. Annual appropriations acts require that the audited agency develop a formal response within 60 days after release of the audit report.

We appreciate the courtesy and cooperation extended to us during this audit.

AUDITOR GENERAL

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EASTERN MICHIGAN UNIVERSITY

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Description of University House Project

The University House is a 10,000-square-foot multipurpose structure located on Hewitt Road adjacent to the Convocation Center.

The Hewitt Road property was purchased in September 2000. In April 2001, the Board of Regents approved the selection of the designer/builder for the project.

In June 2001, the Eastern Michigan University Board of Regents approved the construction of the University House as a $3.5 million project. The University intended for the facility to enhance and preserve the University's institutional heritage and to drive its future by showcasing the University's research and scholarship activities, hosting fund-raising events, and housing visiting scholars and dignitaries, as well as serving as the official residence of the University President.

Excavation work on the project started in October 2001, and 21 months later the University President took occupancy of the University House in July 2003.

In June 2000, the University purchased a temporary residence off campus for the University President. This residence was subsequently sold in June 2003.

Audit Objectives, Scope, and Methodology
and Agency Responses

Audit Objectives

Our performance audit* of the University House Project, Eastern Michigan University, had the following objectives:

1. To identify, by source, the total amount of funding for the University House project.

2. To determine total expenditures related to the University House project.

3. To determine if operating revenues were used in funding the University House project.

4. To determine if the University House project funding and expenditures were accounted for in accordance with applicable statutes.

5. To determine if the University maintained sufficient management control* over the University House project.

This performance audit was conducted as a legislative request for information.

Audit Scope

Our audit scope was to examine the program and other records of the University House project. Our audit was conducted in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States and, accordingly, included such tests of the records and such other auditing procedures as we considered necessary in the circumstances.

Audit Methodology

Our audit procedures, performed from October 2003 through February 2004, included examining the University House project's records and activities primarily for the period May 1, 2000 through December 31, 2003.

** See glossary at end of report for definition.*

We conducted a preliminary review of the Eastern Michigan University operations related to the University House project to gain an understanding of the University's activities and to formulate a basis for defining the audit scope. This included interviewing University personnel and reviewing applicable statutes, rules, policies, procedures, and other reference materials.

We examined the selection process for the designer/builder and the University House construction process. We reviewed physical plant project files and payments to vendors through the University's accounting system. We examined procurement card activity for the project and reviewed records of the Eastern Michigan University Foundation and meeting minutes of the University's Board of Regents. We reviewed revenue sources identified by the University for the University House project.

Agency Responses

Our audit report contains 4 recommendations. The University's preliminary response indicated that it agrees with all 4 recommendations.

The agency preliminary response that follows each recommendation in our report was taken from the University's written comments and oral discussion subsequent to our audit fieldwork. Annual appropriations acts require the principal executive officer of the audited institution to submit a written response to our audit to the Auditor General, the House and Senate Fiscal Agencies, and the State budget director. The response is due within 60 days after the audit report has been issued and should specify the action taken by the institution regarding the audit report's recommendations.

Background

Annual capital outlay appropriations acts require State universities to obtain authorization from the Joint Capital Outlay Subcommittee (JCOS) prior to letting a contract for new construction of a non-State-funded project estimated to cost more than $1 million. Such authorization is obtained when JCOS and Department of Management and Budget (DMB) approve the use and financing statement. Per the appropriations acts, new construction includes land or property acquisition, remodeling and additions, and maintenance projects. JCOS policy requires that the use and financing statement define the source of all funds or other revenue that will be used to fund the capital costs of the project. These costs include principal, interest, administrative fees, and all other costs necessary to provide for the land acquisition, completed construction, and equipping and furnishing of the project.

Specifically, JCOS policy requires that the use and financing statement include information detailing the gross estimated capital improvement or project costs, including a breakdown of land, site development and demolition, construction cost, furnishings, equipment, fees, and any other special costs. JCOS policy also requires the university to specify the source of funds for the capital costs, i.e., borrowed funds, institutional sources, gift, grant, federal funds, partial State appropriation, or any combination thereof. If bonding or other debt service is incurred, the university must state the account, the source of the funds, and the proposed retirement schedule. The policy further requires the university to describe in detail the annual operating financing program and to furnish a realistic itemized estimate of all gross revenues by major fund source and expenses expected to be generated and incurred on an annual basis.

The capital outlay appropriations acts state that if projects are constructed in violation of the acts' requirements, the projects are not eligible to receive State appropriations for purposes of operating the projects or for support of future infrastructure enhancements that are necessitated, in part or in total, by construction of the projects.

To ensure that desired services are obtained at competitive prices and that the business community has a fair and equal opportunity to participate in publicly funded projects, generally accepted and prescribed bidding and contract awarding practices should be followed. Such practices generally involve soliciting sealed bids from either the public or a prequalified list of vendors; eliminating the bids when vendors do not meet the qualifications; collecting and opening sealed bids; reviewing and evaluating bids by a selection committee, selecting the bid that meets or exceeds all of the project quality and list criteria from bids submitted; and having the selection committee present its recommendation, along with its selection rationale, to management for final decision. To ensure economy and avoid graft and favoritism, all competitive bidders should be granted equal consideration by promoting fair, ethical, and legal trade practices.

The Management and Budget Act (Act 431, P.A. 1984, as amended) encourages and promotes competitive bidding from the private sector and requires DMB to determine that competitive bidding is not appropriate before using another procurement method.

COMMENTS, FINDINGS, RECOMMENDATIONS, AND AGENCY PRELIMINARY RESPONSES

FUNDING SOURCES

COMMENT

Audit Objective: To identify, by source, the total amount of funding for the University House project.

Conclusion: As of December 2003, funding included $229,500 in gifts and pledges, $347,407 transferred from the auxiliary fund to the plant fund, and $1,000,000 of future corporate royalties revenue. The source of remaining funding was the University's operating revenues. (Exhibit 1, page 31).

EXPENDITURES

COMMENT

Audit Objective: To determine total expenditures related to the University House project.

Conclusion: Total direct expenditures as of December 2003 were $5.3 million. Total other costs associated with the University House project were an additional $0.7 million. (Exhibit 2, page 32).

OPERATING REVENUES

COMMENT

Audit Objective: To determine if operating revenues were used in funding the University House project.

Conclusion: Operating revenues were used in the University House project. We noted one material condition*. The University used operating revenues to fund the University House project without obtaining approval from the Department of Management and Budget (DMB) and the Joint Capital Outlay Subcommittee (JCOS) (Finding 1).

** See glossary at end of report for definition.*

FINDING

1. **Project Financing**

The University used operating revenues to fund the University House project without obtaining approval from DMB and JCOS.

A substantial portion of the budgeted ($3.5 million) and the total ($5.3 million) direct cost of the University House project was funded using University operating revenues, which is prohibited by annual capital outlay appropriations acts unless approved by DMB and JCOS.

The University identified four sources of funding that it planned for the University House project, approved by the University's Board of Regents as a $3.5 million project in its June 2001 meeting. In the same meeting, the Board committed to no increases in tuition and fees to finance the University House project, including construction and operation. Further, in its use and financing statement submitted for JCOS approval on July 7, 2003, the University stated that there would be no increase in tuition and fees to finance the project. However, the University's funding of the University House project did require the use of operating revenues, which are derived from student tuition and fees and State appropriations. As shown in Exhibit 1 on page 31, the funding sources identified by the University included debt refinancing, corporate royalties, gifts and gifts-in-kind, and the transfer of the former President's house to the auxiliary fund:

a. Debt Refinancing

In its use and financing statement, the University described "debt refinancing savings" as a source of funds for the University House project. Our analysis of the related transactions disclosed the following:

(1) On June 6, 2001, the University entered into an option agreement for the prospective refunding of its 1992 General Revenue Refunding Bonds. The agreement involved selling to an investment banker an option to purchase University bonds at an interest rate of 5.80% (a premium of 1.97% over the then-prevailing rate of 3.83%) with the bond proceeds to be used to refund the 1992 General Revenue Refunding Bonds. The option was exercisable from February 1, 2002 through April 2, 2002. The investment banker exercised the option on February 1, 2002. In March 2002, the University issued $21,100,000 of General Revenue Bonds,

Series 2002A, to refund the $20,615,000 1992 General Revenue Refunding Bonds, incurring additional indebtedness of $485,000, and recorded an accounting gain of $662,298. In consideration of the additional indebtedness and the higher interest rate, the investment banker paid the University a $730,000 premium. The bonds are payable from the general revenues of the University, which are derived largely from student tuition and fees and State appropriations. The increase in debt service (amount required to retire the bonds) is $266,921.

(2) In August 2001, the University entered into a 26-year interest rate swap agreement for $41,395,000 of variable rate 2001 Series General Revenue Bonds to defease in substance $38,460,000 of General Revenue Bonds of 1997, incurring additional indebtedness of $2,935,000, and recorded an accounting loss of $1,020,872. The "bond swap*" was designed to "synthesize" the variable rate that the University was paying on the General Revenue Bonds of 1997. The interest rate for the bond swap was 4.72%, a premium of .47% over the then-prevailing rate of 4.25%. In consideration of the additional indebtedness and the higher interest rate, the investment banker paid the University a $1,236,618 premium. The bonds are payable from the general revenues of the University, which are derived largely from student tuition and fees and State appropriations. The decrease in debt service (amount required to retire the bonds) is $16,678.

b. <u>Corporate Royalties</u>

The University directed, to the University House project, $1 million of future corporate royalties originating with 1998 contractual agreements that the University established with two companies: first, a financial institution issuing credit cards bearing the University's name and, second, a beverage company receiving exclusive rights to sell beverage products on campus. The agreements included fixed and staggered payments to the University over 7-year and 10-year periods, respectively. Prior to the University House project, such revenue was designated and expended to benefit student initiatives, such as the Student Organization Center, the Student Advancement Fund, and computers for student use in the library. Directing the royalty revenue to the University House project reduced the University's ability to fund

** See glossary at end of report for definition.*

similar initiatives because the respective funding was no longer available for such purposes.

Also, the royalty revenue directed to the University House project will not be received until June 30, 2004 ($750,000) and March 31, 2005 ($250,000). In the interim, the University expended corresponding amounts of its common cash pool for the project. Further, the University incurred lost interest earning opportunity related to the use of these funds in anticipation of royalty revenue.

c. <u>Gifts and Gifts-in-Kind</u>

In its use and financing statement submitted to DMB on July 7, 2003, the University reported $935,000 as private funding from gifts and gifts-in-kind. However, as of December 2003, the University collected only $129,500 in gifts. There is a cash pledge of $50,000 to be received by October 2004 and a cash pledge of $50,000 to be received by September 2008.

d. <u>Transfer of Former President's House to Auxiliary Fund</u>

The University transferred the former President's house from its plant fund to its auxiliary fund and recorded a transfer of $347,407 from its auxiliary fund to its plant fund, which the University made available for the University House project. This transfer represented an exchange of assets between funds.

In summary, as of December 2003, funding for the $5.3 million in direct costs of the University House project that did not involve the use of operating revenues included $229,500 in gifts and pledges, $347,407 transferred from the auxiliary fund to the plant fund, and $1,000,000 of future corporate royalties revenue. The remainder of the funding ($3.7 million) was derived from the University's general operating funds (student tuition, fees, and State appropriations), which is prohibited by annual capital outlay appropriations acts without the specific approval of DMB and JCOS.

In the same June 2001 meeting in which the Board of Regents committed to no increases in tuition and fees to finance the University House project, it also approved a new program fee for University students. The next year, program fees were increased and a liberal arts fee was initiated. Also, the University increased student tuition each year during construction of the University House project. For example, annual tuition increases by course level ranged from 8% to 22% from academic year 2000-01 to academic year 2002-03. Student tuition and fees account for a substantial portion of the University's general revenue, a source of funding for costs of the University House project. A variety of factors impact the need to increase student tuition and fees, including rising personnel costs and decreased State funding. Thus, the University House project is only one of several factors that could impact a decision to increase student tuition and fees.

RECOMMENDATION

To comply with capital outlay appropriations acts, we recommend that the University obtain approval from DMB and JCOS before using operating revenues to fund capital outlay projects.

AGENCY PRELIMINARY RESPONSE

The University takes strong exception to the "Project Financing" conclusion and several points within the finding. The University agrees with the recommendation to comply with capital outlay appropriations acts.

The University House project was not debt-financed as is implied in the finding. The refinancing was a prudent and common debt management strategy regardless of the use of the savings.

The swap and option savings associated with the refinancing of the debt ($2.0 million received in up-front cash proceeds), not the increased principal, was a significant source of funding for the University House project. The use of the savings and the accounting treatment of the refinancing are in accordance with guidance from the University's investment banking adviser, Piper Jaffray Education Finance Practice, and the University's external auditors, PricewaterhouseCoopers.

While the University awaits the final installments of royalty payments, existing unrestricted royalty reserves are being used to supplement project cash flow. Operating funds have not been used for this purpose. As such, there was no loss of investment income on any operating funds.

To imply that the program fee was related to the University House project is incorrect. Tuition and fee increases ensure the long-term financial viability of University operations. The support documentation that led to the approval of this fee clearly details the ongoing operating costs the fee was intended to fund. In addition, there was also documentation of the precedent of other State universities instituting similar fees previous to the approval of this fee at Eastern Michigan University.

The Office of the Auditor General implies in this report that the University House project was funded both by the issuance of debt and the implementation of a new program fee. This implication is incorrect. The project (as described and defined in response to Finding 2) was funded by debt refinancing savings, royalties, gifts, and the transfer of the former President's residence to the auxiliary fund for student housing.

The additional expenses incurred for developing the property outside the project perimeter (as described and defined in response to Finding 2) were funded by University reserves, auxiliary operations, and campus beautification, all sources of funding that were within the authority of the University to commit to such a project.

OFFICE OF THE AUDITOR GENERAL EPILOGUE

The University's claim that it used royalty reserves is in conflict with the fact that as of December 2003, the royalty reserves were accounted for in the alumni relations account where they have been since April 1998. It is questionable whether the University can continue to account for funds in the alumni relations account and simultaneously use the funds to pay for the University House project. It is notable that by its own accounting, royalty reserves were not a source of funding for the University House project. As of October 2003, University records reflected a $1.2 million negative fund balance in the University House project account.

The University's denial that student fees helped fund the University House project contradicts its own statement that portions of the project were funded by University reserves, auxiliary operations, and campus Beautification because these funding sources are comprised of revenues that originate with student fees.

COMPLIANCE WITH STATUTES

COMMENT

Audit Objective: To determine if the University House project funding and expenditures were accounted for in accordance with applicable statutes.

Conclusion: The University House project funding and expenditures were not accounted for in accordance with applicable statutes. We noted two material conditions. The University did not maintain sufficient budgetary control over the University House project expenditures (Finding 2). Also, the University did not comply with annual capital outlay appropriations acts with respect to the University House capital outlay project (Finding 3).

FINDING

2. Budgetary Control

The University did not maintain sufficient budgetary control over the University House project expenditures.

As a result, the University's Board of Regents was not appropriately apprised of escalating costs related to the project. After learning that the total cost of the project exceeded the original cost projection in August 2003, the Board contracted for a review of the entire project. Also, as more fully described in Finding 3, the University did not include all of the University House project expenditures in its use and financing statement as required by JCOS policy.

In June 2001, the University's Board of Regents approved the University House project with a construction cost of $2.8 million. Also, site work, landscaping, parking, furnishings, equipment, and other indirect costs and contingencies were projected to total $0.7 million, bringing the total Board-approved project cost to $3.5 million.

For budgetary purposes, the University established a University House project account to record expenditures during construction. However, upon completion of the project, the University had recorded in this account only $3.6 million of direct expenditures related to the University House project. As shown in Exhibit 2 on page 32 of this report, we noted other direct expenditures and costs associated with the University House project and President housing as follows:

a. The University recorded approximately $1.3 million of direct University House construction related costs in six other accounts. These costs included site work and landscaping under campus beautification, campus utility infrastructure, transitional zone preparation, parking and paving, fire protection/security watch, and service kitchen equipment.

b. The University expended approximately $0.4 million for the Hewitt Road land acquisition.

c. The University expended approximately $0.2 million for renovations to the former President's house (Forest Avenue) and for the President's temporary residence (Stonebridge property) during construction of the University House.

d. The University expended approximately $0.2 million for the Board-appointed review of the University House project.

e. The University incurred debt refinancing costs of approximately $0.4 million, as more fully discussed in Finding 1.

For accounting and approval purposes, the University defined the University House project to include only the costs within a ten-foot perimeter of the building. However, DMB requires disclosure of site development costs without a boundary limitation. Further, as depicted in the University House site plan presented as Exhibit 3 on page 33, there are no other structures within the approximately eight-acre fenced and gated property that would derive common benefit from new infrastructure or other site improvements. Thus, we believe these costs are directly related to the University House project and should have been disclosed in the use and financing statement. Defining the University House project in this manner obfuscates the true cost of the project and is inconsistent with the use and financing statement requirements and the need for full disclosure to the JCOS and the University's Board of Regents.

As of February 2004, the University House project was not closed out because final invoices and retainage had not been paid. Thus, upon the completion of our audit fieldwork, the final cost of the University House project could not be fully determined.

RECOMMENDATION

We recommend that the University maintain sufficient budgetary control over expenditures related to capital outlay projects.

AGENCY PRELIMINARY RESPONSE

The University takes strong exception to the "Budgetary Control" conclusion and several points within the finding. The University agrees with the recommendation to continue to maintain sufficient budgetary control over expenditures related to capital outlay projects.

Much attention has been directed toward the ultimate cost of the University House. The confusion relates to the definition of capital projects. For as far back as it can identify, Eastern Michigan University has defined capital projects as all work done within five feet of the foundation of the new structure. This definition was developed many years ago from the use and financing statement, which requires the estimated cost of "services from five feet outside of the structure." This same language is used in the State of Michigan Department of Management and Budget, Office of Facilities, Design and Construction Division's Major Project Design Manual for Professional Service Contractors, State Universities, Community Colleges, and State Agencies. Because of the uniqueness of this project, the perimeter was expanded to ten feet. The University's understanding is that Eastern Michigan University projects run by the State of Michigan have also used this five-foot standard to determine the costs to be charged to the project account. Also, capital outlay projects such as the College of Health and Human Services Building were completed using this project definition and have been approved and accepted by the State. No other project definition has been offered by the Joint Capital Outlay Subcommittee or the Office of the Auditor General. Projected costs using this longstanding definition were $3.5 million. Actual costs within the defined perimeter were $3.58 million.

The University continues to acknowledge that additional costs were incurred for the development of the property outside the defined project perimeter, including: land acquisition, $423,809 (this expenditure should have been included in the use and financing statement); land and infrastructure improvements, $1,102,586; property fire protection and security, $90,272; and a commercial kitchen, $75,953 (paid for, as is standard, by EMU Dining Services and arguably, it should have been included in the use and financing statement). These costs were properly budgeted and accounted for in accounts designed for these purposes. Furthermore, it made long-term sense to spend $111,406 for the electrical infrastructure at the time the University House was being constructed, reducing future development costs on West Campus.

Expenditures listed in the report in items c. and d. (maintenance and operation of the President's temporary residence (Stonebridge) and former residence (Forest Avenue) and the Board authorized project audit) are unrelated to the construction of the University House, did not influence decisions related to the construction, and should not be considered in relation to this construction project.

The University agrees that improvement in project management is nearly always attainable and the University always strives to make such improvements. As an example, the University has significantly improved its capital project reporting to the Board of Regents by providing more detailed and thorough reports.

OFFICE OF THE AUDITOR GENERAL EPILOGUE

Narrowing the scope of the University House project for cost disclosure purposes by including only costs incurred within a building perimeter of ten feet obfuscates the true cost of the project and is inconsistent with requirements of the use and financing statement provisions and the need for full disclosure to the JCOS and the University's Board of Regents. The University cites the five-foot disclosure requirement contained within the DMB and use and financing statement provisions, but it ignored requirements of the same provisions that provide for disclosure of all other costs as site development.

FINDING

3. Use and Financing Statement

The University did not comply with annual capital outlay appropriations acts with respect to the University House capital outlay project.

The acts state that a university shall not let a contract for new construction of a non-State-funded project estimated to cost more than $1 million unless the project is authorized by JCOS through approval of a use and financing statement defined by a policy adopted by JCOS. The use and financing statement shall contain the estimated total construction cost and all associated estimated operating costs, including a statement of anticipated project revenues.

We noted the following:

a. <u>JCOS Approval</u>

The University did not submit use and financing statements and receive JCOS approval for the University House capital outlay project prior to awarding contracts and completing the project.

Capital outlay appropriations acts require that universities obtain JCOS approval prior to starting non-State-funded capital outlay projects exceeding $1 million. Without JCOS approval, projects are not eligible for future State operational funding or infrastructure enhancements.

The University's Board of Regents approved the non-State-funded, University House capital outlay project in June 2001. However, the University did not submit a use and financing statement to JCOS until July 7, 2003, after the project was completed.

b. <u>Accuracy and Completeness</u>

The University did not include all costs and financing known to the University at the time that it submitted the use and financing statement for the University House capital outlay project.

To aid in assessing the propriety of proposed projects, JCOS requires that universities submit a project use and financing statement describing the need for the project, the estimated construction and operating costs, and the anticipated project revenue.

JCOS policy requires that the use and financing statement define the sources of all funds or other revenue which are to be used to pay the capital costs of the project. These costs include principal, interest, administrative fees, and all other costs necessary to provide for the land acquisition, completed construction, equipping, and furnishing of the project. All associated operating costs are also required on the use and financing statement.

Although the University submitted its use and financing statement to JCOS after the project was completed, it was not an accurate representation of known project costs and funding. Direct project costs were $5.3 million, whereas the use and financing statement listed project costs of $3.5 million.

The use and financing statement identified funding of $3.5 million. However, as of December 2003, funding that was not operating revenue included $229,500 in gifts and pledges, $347,407 transferred from the auxiliary fund to the plant fund, and $1,000,000 of future corporate royalties revenue.

Further, the University did not make all of the required disclosures in its use and financing statement for the University House project. The following items were not included:

a. Land
   Land acquisition cost was $424,000.

b. Principal and Interest
   The University's bond refinancing transactions resulted in increased principal of $3,420,000. Future interest associated with the additional principal is $2,869,000. However, it is questionable how much of these amounts require disclosure in the University House use and financing statement. Although the University paid a premium interest rate on both bond issuances, future debt service on the bonds increased by only $250,243 over the bonds that were refunded.

RECOMMENDATION

We recommend that the University comply with annual capital outlay appropriations acts with respect to capital outlay projects.

AGENCY PRELIMINARY RESPONSE

The University agrees with the "Use and Financing Statement" findings, with two exceptions. The University agrees with the recommendation to comply with annual capital outlay appropriations acts with respect to capital outlay projects.

The University fully acknowledges its failure to submit a use and financing statement in a timely and complete manner.

First exception to the finding: Reiterating the response from Finding 2, the inclusion of certain expenditures in the use and financing statement is directly related to the University's definition of a capital project, which is all work done within five feet of the structure's foundation. Within this longstanding definition, and in the absence of any other guidance, the University feels that it met the intent of the use and financing statement except for the land acquisition and commercial kitchen. The failure to include the purchase price of the land was an inadvertent oversight. All previous use and financing statement submissions were for projects constructed, renovated, or maintained on property owned by the University for decades; therefore, land acquisition costs have never previously been reported. The commercial kitchen was not included on the use and financing statement since it was funded by EMU Dining Services to support its catering services.

Second exception to the finding: The University disagrees that the increase in principal with an imputed interest rate should have been noted on the use and financing statement. This project was not debt financed. The increase in principal and decrease in interest was related to wise financial stewardship through debt management which resulted in $2.0 million in up-front cash proceeds. The University does not believe the finding addresses the intent of the use and financing statement guidelines. If that was the intent, the proper reporting would have to show increased principal and decreased interest expense related to the entire debt refinancing.

We have implemented procedures and controls to identify and monitor projects that require use and financing statements to ensure that they are filed in a timely manner. In addition, we strongly support the efforts of the Joint Capital Outlay Subcommittee and the Office of the Auditor General in reviewing the use and financing statement guidelines.

MANAGEMENT CONTROL

COMMENT

Audit Objective: To determine if the University maintained sufficient management control over the University House project.

Conclusion: The University did not maintain sufficient management control over the University House project. In addition to the material conditions related to project financing, budgetary control, and the use and financing statement (Findings 1 through 3), we also noted a reportable condition* related to the University's contract bidding process (Finding 4).

FINDING

4. Contract Bidding Process

The University needs to improve its competitive bidding process for selecting contractors and awarding construction contracts.

Use of sound business practices when bidding and awarding publicly funded contracts helps ensure that desired products and services are acquired at competitive prices and that the business community has a fair and equal opportunity to participate in publicly funded projects.

The University's bid process included seeking recommendations for qualified builder/architect teams from builders' associations and others, soliciting sealed bids from qualified bidders, holding a mandatory meeting of potential bidders, and using a selection committee to review and evaluate bids.

However, our review of the bidding process disclosed the following deficiencies for the University House project:

a. The University did not conduct a public opening of sealed bids to select the University House designer/builder and the landscape contractor. Public bid openings give bidders and other interested parties assurance about the integrity of the bidding process.

b. The University did not prepare a written log to support the receipt of competitive bids.

c. The contract for the designer/builder was signed after the project began.

d. Stringent time lines established by the University for the University House project resulted in only three bidders. Other available bidders reported being discouraged as a result of the established time lines (projected completion by

** See glossary at end of report for definition.*

July 1, 2002). Further evidence that the project time lines were too stringent is the fact that the project was not substantially complete until July 2003.

e. Bid documentation indicated that the University had contacts with the winning bidder prior to the awarding of the contract that were not apparent with the other bidders.

f. The winning bidder for a landscaping contract did not provide the rates to be charged during the contract until three weeks after the bid opening.

Recommendation

We recommend that the University improve its competitive bidding process for selecting contractors and awarding construction contracts.

Agency Preliminary Response

The University takes strong exception to the "Contract Bidding Process" conclusion and several of the points within the finding. The University agrees with the recommendation to improve the competitive bidding process.

The University regularly reviews its competitive bidding policy to ensure that it is consistent with current best practices. Exceptions to the deficiencies noted in the audit report are addressed individually below:

a. The University recognizes that a public opening could, at times, be of value; but for complicated bids that take weeks to evaluate, such as those for the University House project, the value added is debatable.

b. A written log of bids was prepared but was not properly filed and maintained. This procedure is followed regularly but the filing of such information needs strengthening.

c. The final contract was signed after initiation of the project. Due to the project's time constraints, a draft contract was used to guide the project while the final contract was structured. The portion of work being completed during this period was the design process only. A detailed project scope document and an offer letter were on file limiting the University's exposure.

d. The number of bids received by the University fully satisfied the University's policies and procedures, which require a minimum of three bids, and also satisfied the current National Association of College and University Business Officers (NACUBO) recommendation to obtain three to six bids. In regard to bidders being discouraged, it is not uncommon for contractors to decline to bid due to any number of reasons associated with their skills, abilities, other business commitments, or the timing of the project. As was expected, some contractors were willing to bid while others were not.

e. The letter used as evidence of contact with the winning bidder prior to awarding the contract was actually sent subsequent to the bid evaluation process by the selection committee. The committee made a preliminary decision based on ability, timing, and cost but sought confirmation of the winning bidder's commitment to meet the project objectives. The University feels this was appropriate due diligence.

Finally, the current NACUBO standards for competitive bidding found on its website, as well as the "generally accepted and prescribed bidding and contract awarding practices" noted in the "Background" section of the audit report, were fully complied with and exceeded. The University continues to review and attempts to strengthen the University's bidding policies and procedures.

OFFICE OF THE AUDITOR GENERAL EPILOGUE

The University asserts that its contact with the winning bidder was subsequent to the bid evaluation process of the selection committee. However, as stated by the University in item a. of its response, complicated bids take weeks to evaluate, such as those for the University House project. The contact referred to in item e. of the finding occurred on the day following the bid opening. The contact was a letter requesting the bidder to clarify its bid, to which the bidder responded. Other bidders were not afforded equal opportunity to clarify their bids.

SUPPLEMENTAL INFORMATION

Exhibit 1

UNIVERSITY HOUSE PROJECT
Eastern Michigan University
Funding Sources
As of December 2003

Description	Reported in Use and Financing Statement	Funding From Nonoperating Revenue: Realized as of December 2003	Projected: Fiscal Year 2003-04	Projected: Fiscal Year 2004-05	Projected: Fiscal Year 2008-09	Total	Funding From Operating Revenue	Total Funding
Debt refinancing	$ 1,225,000						$ 1,990,776	$ 1,990,776
Corporate royalties	1,000,000		$ 750,000	$ 250,000		$ 1,000,000		1,000,000
Gifts and gifts-in-kind	935,000 *	$ 129,500		50,000	$ 50,000	229,500		229,500
Transfer of former President's house to auxiliary fund	340,000	347,407				347,407		347,407
Other operating revenue	0						1,749,386	1,749,386
Total Funding	$ 3,500,000	$ 476,907	$ 750,000	$ 300,000	$ 50,000	$ 1,576,907	$ 3,740,162	$ 5,317,069 **

* Gifts and gifts-in-kind include $650,000 from reduced pricing by the contractor and subcontractors and pledges of $100,000.

** Total direct expenditures for the University House project were $5,317,069.

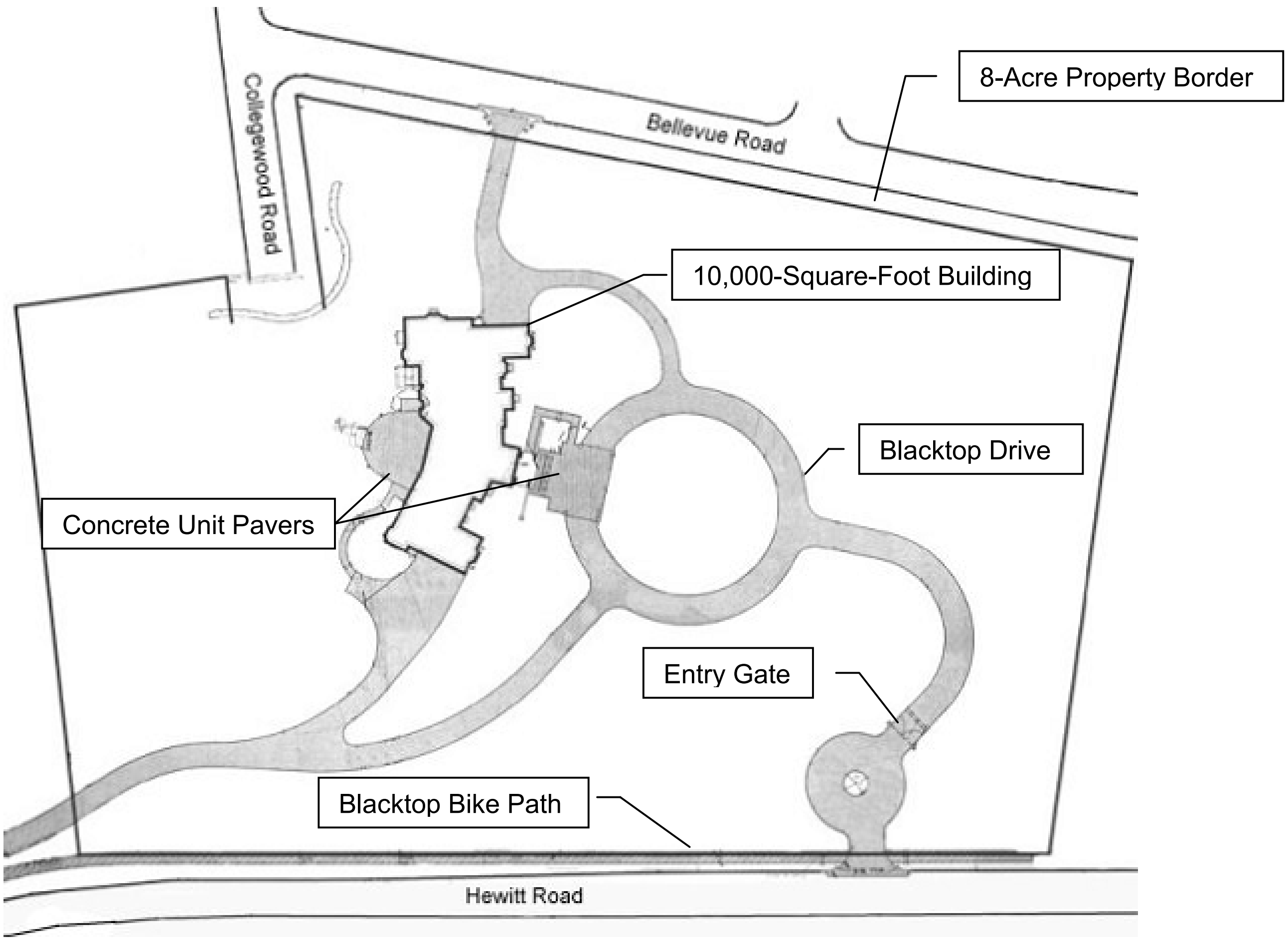
Exhibit 2

UNIVERSITY HOUSE PROJECT
Eastern Michigan University
Direct Expenditures and Other Costs
Associated With University House Project and President Housing
As of December 2003

DIRECT EXPENDITURES	
University House Project account	$ 3,584,331
Campus beautification	861,091
Campus utility infrastructure	111,406
Transitional zone preparation	45,048
Parking and paving	113,133
Fire protection/security watch	90,272
Service kitchen equipment	75,953
Eastern Michigan University Foundation - Furnishings and china	12,026
Hewitt Road land acquisition	423,809
Total Direct Expenditures	$ 5,317,069
OTHER COSTS ASSOCIATED WITH UNIVERSITY HOUSE PROJECT AND PRESIDENT HOUSING	
Forest Avenue property renovations	$ 88,265
Stonebridge property losses	91,285
Board-appointed review of the University House project	198,960
Net cost of bond option (June 2001; recorded gain of $662,298) and bond swap (August 2001; recorded loss of $1,020,872) debt refinancing to University (Finding 1)	358,574
Total Other Costs Associated With University House Project and President Housing	$ 737,084

Exhibit 3

UNIVERSITY HOUSE PROJECT
Eastern Michigan University
University Site Plan



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GLOSSARY

Glossary of Acronyms and Terms

bond swap	An agreement between two counter-parties in which the cash flows from two bonds are exchanged as they are received for a fixed time period. In the University's swap, it sold variable rate bonds and a derivative (the swap) whereby the University paid a fixed rate of interest to a counter-party and the counter-party paid the University a variable rate in return.
DMB	Department of Management and Budget.
JCOS	Joint Capital Outlay Subcommittee.
management control	The plan of organization, methods, and procedures adopted by management to provide reasonable assistance that goals are met; resources are used in compliance with laws and regulations; valid and reliable data is obtained and reported; and resources are safeguarded against waste, loss, and misuse.
material condition	A reportable condition that could impair the ability of management to operate a program in an effective and efficient manner and/or could adversely affect the judgment of an interested person concerning the effectiveness and efficiency of the program.
NACUBO	National Association of College and University Business Officers.
performance audit	An economy and efficiency audit or a program audit that is designed to provide an independent assessment of the performance of a governmental entity, program, activity, or function to improve public accountability and to facilitate decision making by parties responsible for overseeing or initiating corrective action.

reportable condition

A matter that, in the auditor's judgment, represents either an opportunity for improvement or a significant deficiency in management's ability to operate a program in an effective and efficient manner.