



EDWARD B. HATCHETT, JR.
AUDITOR OF PUBLIC ACCOUNTS

April 17, 2000

Kevin Noland
Interim Commissioner
Department of Education
Capital Plaza Tower
500 Mero Street
Frankfort, Kentucky 40601

RE: Special Examination of Case #1999-0045 – Kentucky Department of Education (KDE)
Irregularities and Related Issues

Dear Commissioner Noland:

This is the second interim report informing you of findings we have made to date in our special examination of issues pertaining to the recent irregularities involving the transfer and subsequent use of KDE funds at the Kentucky Educational Development Corporation (KEDC), an educational co-operative. Our examination has led us to examine money transfers between KDE and other educational co-operatives, and between KDE and two local school districts.

We question (1) certain managerial practices, discussed herein, contributing to the inconsistent application of statutes governing personnel issues, (2) the transfer of funds from KDE to educational co-operatives or other agents, (3) the use of funds for both inappropriate purposes and for program purposes other than those for which the funds were designated, and (4) the absence of sound business practices that assure the effective employment of tax dollars for education.

The findings noted to date in our examination of KDE are as follows:

KDE circumvented the Commonwealth's budget appropriation lapsing statute

KDE used its relationship with the educational co-operatives and at least two local school districts to circumvent KRS 45.229. This statute requires state agencies to return unexpended or unobligated allotments at the close of any fiscal year to the Commonwealth's general fund. While it is commonplace for agencies of state government to tailor their spending to an annual budget allocation, KDE appears to resort to subterfuge by transferring money it characterizes as "grants" to co-operatives and school districts for use in subsequent budget periods. This practice undermines the integrity of the legislative budgeting process and belies proper planning for the timely expenditure of education dollars. We identified over \$2.9 million in the last three fiscal years sent to co-operatives and school districts to hold until KDE issued spending instructions. A balance of nearly \$2.8 million remained unspent beyond the year of the general fund appropriation.

KDE maintained control of funds redirected to co-operatives

KDE officials stated that as part of a "lapse-reduction" process, KDE account balances are routinely scrutinized in April or May of each year to initiate the process of redirecting funds to the co-operatives. While KDE funds are typically granted through a contract to the co-operatives, the grant disbursements are often inconsistent with the stated purpose of the grant. Furthermore, KDE usually maintains full control of these funds while the co-operatives process payments at the direction of KDE.

The appendix to this interim report lists 24 grants from KDE made near the close of each of the last three fiscal years. The appendix illustrates KDE's redirection of funds for subsequent expenditures.

Over \$500,000 was embezzled from funds redirected to KEDC

KEDC received grants totaling \$2,075,500 authorized solely by former KDE Deputy Commissioner Randy Kimbrough. [See appendix.] Ms Kimbrough pled guilty in U.S. District Court to the charge of embezzling over \$500,000 by authorizing payments to fictitious vendors. All of the funds embezzled were from grants redirected to KEDC authorized by Ms Kimbrough.

Other KDE "grants" redirected to avoid lapsing are bulleted below. None of these funds was expended or obligated by the grant recipients prior to June 30, 1999. Please refer to the Appendix for a chart of all grant transfers examined.

Redirected funds controlled by KDE were held beyond grant periods

- In June 1999, four co-operatives received grants from KDE totaling \$355,000. Though each of the four grant periods was to expire June 30, 1999, a cumulative balance of \$281,329 in the four grants remained after that date. As discussed in our comment beginning on page four, \$170,208 was paid from these grants to satisfy a direct obligation of KDE incurred during or after the close of the fiscal year.
- The Elizabethtown Independent School District (Elizabethtown School District) received a grant from KDE on June 14, 1999, for \$133,900. The grant expiration date was June 30, 1999. A detailed explanation of a \$69,792 expenditure made from this grant is provided in our comment beginning on page four. The remaining balance of \$60,208 continued to be held by the Elizabethtown School District beyond the grant period, and as of April 17, 2000, the remaining balance was \$55,208.
- In July 1997, the Ohio Valley Educational Co-operative (OVEC) received a \$169,612 grant from KDE with a July 1, 1996, effective date. There was no expiration date for this grant. No expenditure was made from this account until April 1999, as discussed in our comment beginning on page four. As of April 17, 2000, the remaining balance was \$104,672.
- The Oldham County School District received two grants totaling \$139,000 in June 1999. The district was to act as KDE's fiscal agent for two professional development programs. While the grant periods ended June 30, 1999, no expenditures were made by that date. Expenditures totaling only \$4,281 were made from these grants as of April 13, 2000, and a balance of \$134,719 remains as of April 17, 2000.
- KEDC received a \$50,000 professional development grant in June 1999. According to the terms of the grant, all expenditures were to be made by June 30, 1999. The only expenditure made from this grant as of April 17, 2000, was for the KEDC \$2,500 administrative fee.

KDE awarded grants without a memorandum of agreement

We note that many of these grants were awarded through a purchase order without a memorandum of agreement (MOA). Grants issued through a MOA specified a time period during which the services contracted for were to be performed. KDE ignored the contract periods associated with funds redirected at year end. Several grants sent to the co-operatives came from budget units unrelated to the stated purpose of the grant. For example, a \$60,000 technology grant to KEDC in July 1998 came from a school food program account at KDE. Finally, we confirmed with seven co-operatives that KDE did not direct the return of unexpended state grant money.

Recommendations

We recommend KDE adhere to the provisions of KRS 45.229 and the Budget of the Commonwealth. These statutes legally bind KDE to a spending plan. KDE should ensure that the services contemplated by grants to co-operatives are performed within the fiscal year to which the underlying appropriation applies.

We recommend KDE lapse any unobligated funds to the Commonwealth's general fund. Likewise, KDE should require the co-ops to return funds unexpended at the end of the grant period. KDE should monitor the activity of its co-operative grants to ensure the programs are carried out in a timely manner.

We recommend that KDE execute a MOA prior to making every grant, and that KDE abide by the terms of the grant. KDE will thereby reduce the risk of fraud and other inappropriate uses of public funds.

KDE directed payment of \$300,000 to The National Faculty in violation of the Commonwealth's purchasing laws

KDE circumvented the provisions of the Commonwealth's Model Procurement Code by directing payment of \$300,000 to The National Faculty (TNF) without having a written contract for services. TNF is an Atlanta-based non-profit organization, which markets professional development services. By routing the payments to TNF through five educational co-operatives and a local school district, KDE placed the transaction outside the customary scrutiny of the Finance and Administration Cabinet, the Legislative Research Commission, and the Auditor of Public Accounts.

The Model Procurement Code is set out in KRS Chapter 45A. KRS 45A.045(2) states "[t]he Finance and Administration Cabinet . . . shall have supervision over all purchases by the various spending agencies . . . and . . . shall promulgate administrative regulations to govern purchasing by and for all these agencies." This section further states "[n]o purchase or contract shall be binding on the state or any agency thereof unless approved by the Finance and Administration Cabinet or made under general administrative regulations promulgated by the cabinet." The services provided by TNF to KDE appear to be professional services. Contracts for services of this type are required by KRS 45A.690 through 45A.725 to be reviewed and approved by the Government Contract Review Committee of the Legislative Research Commission and the Secretary of the Finance and Administration Cabinet before any payment is made.

KDE practices circumvent accountability and increase risk

Tom Peterson, KDE Associate Commissioner, whose duties include the administration of professional development, said that paying for professional development services through the educational co-operatives was customary for the department. By circumventing the Commonwealth's procurement laws KDE diminishes accountability and thereby increases the risk of misusing public funds.

The circumstances and sequence of events attending the payment of \$300,000 to TNF for professional development services are as follows:

Funds were diverted on the unilateral authority of one administrator

- In July 1997, then KDE Deputy Commissioner Randy Kimbrough, on the authority of her sole signature, sent a \$300,000 grant to KEDC in Ashland for implementation of The National Faculty Training Model. This grant was from a KDE professional development account. Tom Peterson, then KDE's Director of Professional Development, stated he was unaware of this grant to KEDC. The account at KEDC established with this grant was subsequently used by Ms Kimbrough to issue checks totaling \$282,050 to fictitious vendors.

KDE allowed TNF to perform services without a personal service contract

- Beginning in February 1998, KDE discussed with TNF the establishment of a model teacher academy in KDE's Region 8. Although the arrangement was never set out in a written agreement, TNF undertook professional services and issued an invoice to KDE dated February 8, 1999. The invoice claimed an amount due of \$129,792 for teacher training services performed through December 31, 1998.

Local school district and co-op were directed to process payment for KDE obligation

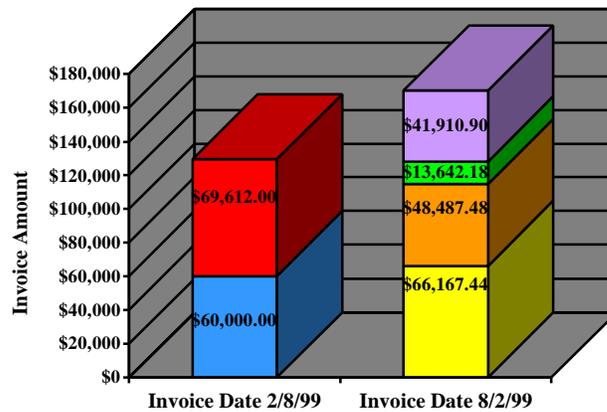
- In April 1999, Mr. Peterson initiated a MOA with the Elizabethtown School District to grant \$133,900 to pay for the services billed KDE by TNF. The grant included an administrative fee to the Elizabethtown School District of \$3,900. The grant was received by the Elizabethtown School District on June 16, 1999. On April 27, 1999, apparently because of repeated requests by TNF for payment of its February invoice, Mr. Peterson directed a partial payment of \$60,000 from grant money held at OVEC. When the Elizabethtown School District received its grant, Mr. Peterson asked that the Elizabethtown School District immediately pay the balance of \$69,792 to TNF and mail the check to his office. The Elizabethtown School District is still holding over \$50,000 of the grant, awaiting expenditure instructions from KDE.
- At the time of the first payment to TNF by OVEC on April 28, 1999, four grants were initiated by KDE to various educational co-operatives for the purpose of establishing regional teacher academies. The following grants were awarded in June 1999: \$40,000 to Northern Kentucky Co-operative for Educational Services (NKCES) for Region 4; \$105,000 to Kentucky Valley Educational Co-operative (KVEC) for Regions 6 and 8; \$105,000 to Badgett Regional Co-operative for Educational Enhancement (BRCEE) for Regions 1 and 2; and \$105,000 to KEDC for Regions 5 and 7.

KDE chose not to formalize or extend a contract for services provided by TNF

Program funds from four co-ops were swept to pay the final TNF invoice

- On June 9, 1999, as a result of an April 1999 meeting between KDE and TNF, the chief financial officer of TNF sent a draft of an agreement to obligate KDE to pay TNF a total of \$900,000 for three years of services consisting of professional development programs in Region 8. The proposal stated that approximately 50 teachers of mathematics would receive professional development training during the three years at a cost of \$18,000 per teacher. KDE never signed this agreement.
- KDE received an invoice for \$170,208 dated August 2, 1999, from TNF for training services performed in Region 8 during the first six months of 1999. In October and November 1999, Mr. Peterson instructed the referenced co-operatives to make payments to TNF from their respective teacher academy grants in the following amounts: \$66,167.44 from BRCEE; \$48,487.48 from KEDC; \$13,642.18 from NKCES; and \$41,910.90 from KVEC. These payments depleted the account balances of these co-operatives' teacher academy grants.

Source of Payments for TNF Invoices



- Payment from KVEC dated 11/17/99. Grant date 6/14/99
- Payment from NKCES dated 11/3/99. Grant date 6/9/1999
- Payment from KEDC dated 11/3/99. Grant date 6/14/99
- Payment from BRCEE dated 10/25/99. Grant date 6/14/99
- Payment from Elizabethtown School District dated 6/30/99. Grant date 6/14/1999
- Payment from OVEC dated 4/28/99. Grant date 7/9/1997

- The payments made to TNF by the co-operatives and the Elizabethtown School District at the direction of KDE totaled \$300,000.
- By failing to pay the TNF invoices in a timely manner, KDE did not comply with KRS 45.453. This statute states “[a]ll bills shall be paid within thirty (30) working days of receipt of goods and services or a vendor’s invoice except when the purchasing agency has transmitted a rejection notice to the vendor.”

This series of transactions also raises the following issues:

Cody’s former relationship with TNF raises ethical questions

- Dr. Wilmer Cody was the regional executive director at TNF’s New Orleans regional office prior to becoming Commissioner of KDE in 1995. Dr. Cody’s previous employment with TNF raises the question of whether a conflict of interests influenced KDE’s business dealings with TNF. At a minimum, his previous employment with TNF gives rise to a perception of a conflict of interests.

Absence of budgetary control placed funds at unnecessary risk

- An absence of awareness of transactions in a professional development budget account by the director of KDE’s Division of Professional Development demonstrates a fundamental lack of control. The fraudulent use of professional development funds diverted to KEDC illustrates the danger posed by inadequate attention by those at appropriate levels.

KDE business practices create needless administrative fees

- By granting funds to a co-operative or a school district for the sole purpose of paying an invoice received by the department, KDE needlessly paid an administrative fee to the co-operative or Elizabethtown School District. In the case of the \$133,900 grant to the Elizabethtown School District, KDE paid the Elizabethtown School District a fee of \$3,900 in consideration for the Elizabethtown School District writing one check to TNF. Officials from the Finance and Administration Cabinet, Empower Kentucky, and the Department of Treasury stated that a check can be created and processed through the Department of Treasury for less than five cents.

KDE directed payments to be processed contrary to the terms of the grants

- Each of the grants from KDE to the co-operatives included a June 30, 1999, expiration date for the expenditure or obligation of the funds. Each grant also specified the regions in which the funds were to be used. The express time and purposes set forth in the grants were ignored when the funds were ultimately expended, illustrating KDE's practice of circumventing the Commonwealth's lapse statute, KRS 45.229, by making transfers to the co-operatives while retaining the authority to direct the co-operatives to make future payments.
- Further evidence of this intention to circumvent is the grant to the Elizabethtown School District. The grant stated an expenditure expiration date of June 30, 1999, yet over \$50,000 of KDE money remains in that account at the Elizabethtown School District.

Recommendations

We recommend that all KDE directors and associate commissioners receive periodic reports on the activities of budget units that fund their programs. An administrator's job function necessarily includes managing the budgets that govern his or her programs. Even a cursory review of the activity in the professional development accounts would have revealed the July 1997 transfer to KEDC of \$300,000 made by Randy Kimbrough. Had a process of reviewing budget activity reports been in place, KDE officials could have detected the transfer and questioned her intentions for establishing the program.

We recommend KDE avoid business relationships that give rise to the perception of conflicts of interests.

We recommend KDE effect a process to ensure invoices are paid within 30 days as required by KRS 45.453.

We recommend that KDE comply with the Commonwealth's procurement laws. As a state agency, KDE is bound by the provisions of the Model Procurement Code as set out in KRS Chapter 45A. Services such as those provided by TNF require the execution of a personal service contract between TNF and KDE, subject to the approval of the Legislative Research Commission and the Finance and Administration Cabinet.

KDE routinely grants money to the educational co-operatives for use in carrying out KDE initiatives at the local level. Since KDE directs the use of the grants by approving all payments and directing all program activity, the co-operatives' role is essentially limited to processing payments. KDE asserts that this service is necessary because it does not have adequate staff to process a large number of relatively small checks. This assertion appears inapplicable to the invoices from TNF. The result of granting funds to co-operatives and a school district to pay the TNF invoices was to bypass the state's accounting system.

We recommend that obligations resulting from KDE procurements be paid directly by KDE, thereby assuring greater accountability. KDE would also save the expense of the administrative fee, typically three to five percent of the grant, by paying these obligations directly.

The inconsistent application of a statute resulted in inflated annual leave accruals for an employee

An examination of personnel files for KDE employees hired through OVEC revealed inconsistencies in handling three employment contracts. The employment process and personnel functions for employees hired through OVEC contracts are managed in the KDE Division of Human Resources. Each of the three subject individuals signed an employment contract on August 16, 1999. Each was formerly employed by a state university and thus could not transfer to the KDE personnel system leave balances for annual, sick, or compensatory time accrued at the universities.

Employment service credit was inconsistently treated for three employees hired on the same day

Upon employment, one of these individuals requested to count 120 months of previous university employment service in calculating benefits and service accruals at KDE. The Director of Human Resources for KDE, an OVEC contract employee, approved the request. The other two employees with previous university employment service were not granted the opportunity to count such prior service. KRS Chapter 18A governs the accrual of annual leave, sick leave, compensatory leave, and fringe benefits for Commonwealth employees, including OVEC employees on contract with KDE.

Inflated annual leave accruals result in an excessive liability to KDE

Granting the employee's request to count previous months of service at the university enabled the employee to accrue annual leave at a more rapid rate than allowed by KRS Chapter 18A. Moreover, the inflated balance of annual leave remaining upon termination of employment with KDE will be paid.

We could find no legal authority allowing KDE to count previous months of service at a university. There is specific reference to local school district employment in KRS 156.026(2) and (3), which allows employees transferring from a local school district to the Department of Education to be given credit for each year of service in the local school district for purposes of determining eligibility for additional leave or other benefits based on longevity of service.

KDE concurs that months of service should not have been counted

The Director of Human Resources for KDE acknowledges that this action was not authorized by KRS 156.026(3). The Director advocates that a policy to ensure compliance with the statute should be established and formally documented in departmental personnel procedures.

Recommendations

We recommend KDE develop and implement a formal written personnel policy to ensure compliance with KRS 156.026(3) and to ensure the consistent calculation of benefits to employees transferring to KDE.

Further, we recommend KDE eliminate the inappropriate crediting of 120 months of employment service of the employee receiving this benefit. The employee should accrue annual leave at the rate appropriate for the months of service accumulated at KDE.

Finally, KDE should recalculate the employee's available leave balance at the rate of 7.5 hours accrued for each month of KDE employment service. If annual leave taken by the employee exceeds the available balance for any given pay period, then KDE should request monetary reimbursement from the employee for each hour of leave exceeding the available leave balance. The payment should be calculated using the employee's hourly salary rate applicable at the time annual leave taken exceeded the employee's available annual leave balance.

KDE should ensure newly established internal audit functions are in compliance with prescribed standards

The Auditor of Public Accounts (APA) affirms the establishment of an internal audit function at KDE. As previously recommended by our office, a properly staffed internal audit function is essential to an organization responsible for administering a budget in excess of \$3 billion.

KDE is uniquely situated to implement an internal audit function. Few state agencies have an independent governance board to which an internal auditor can report. The ability of an internal auditor to report and communicate directly with the board or a subdivision of the board enhances the independence and effectiveness of the audit function.

An internal audit function allows concerns to be expressed to a group independent of management

An internal audit function assists management in establishing a control environment to achieve the objectives of reliable reporting, effective and efficient operations, and compliance with law and regulations. Moreover, this function, if properly placed within the organization, offers an opportunity for employees to express concerns or offer recommendations to an internal group that can independently assess a situation.

Internal audit must be independent and established in compliance with the Institute of Internal Auditors

The internal audit function must be organized and function in compliance with the guidelines and Statements of Internal Auditing Standards established by The Institute of Internal Auditors. The failure to properly implement and to ensure the independence of an internal audit function will render that function useless and negate the goals and objectives established by KDE.

Internal audit standards include independence, interaction with the board, personnel appointment by the board, and a written charter

The Institute of Internal Auditors standards include:

- Internal auditors should be independent of the activities they audit. Independence permits internal auditors to render impartial and unbiased judgments essential to properly conduct an audit.

- The organizational status of the internal audit function should be appropriate to accomplish the audit responsibilities. The internal audit director should have direct communication with the board. Direct communication occurs when the internal audit director attends and participates in board meetings where audit oversight is discussed.
- Independence is strengthened when the board concurs in the appointment or removal of the internal audit director.
- The purpose, authority, and responsibility of the internal audit function should be formally defined in a written document or charter.
- The internal auditor should report activities and audit findings to the board as necessary.
- Internal auditors should not subordinate their judgment in audit matters to others and should not assume operating responsibilities.

Recommendations

We recommend that the Kentucky Board of Education (Board) ensure that an internal audit function is established in accordance with the standards of the Institute of Internal Auditors. Further, we recommend the establishment of an internal audit committee to ensure not only independence but that appropriate action is taken on audit findings. Independence is strengthened by the internal auditor reporting to the audit committee because activities of the agency head must also be assessed. Finally, we recommend that the Board contract with the APA or other independent source to assist in establishing this function.

Very truly yours,



Edward B. Hatchett, Jr.
Auditor of Public Accounts

APPENDIX

Transfers Initiated by KDE Redirecting Funds to Co-op's and School Districts

<u>Grant Date</u>	<u>Grantee</u>	<u>Grant Amount</u>	<u>Grant Period</u>	<u>Expended in KDE'S Fiscal Year</u>	<u>Administrative Fee</u>	<u>Balance at End of KDE's Fiscal Year</u>
7/10/1997	KEDC	\$300,000	*	0	\$15,000	\$300,000
7/10/1997	KEDC	\$300,000	*	0	\$15,000	\$300,000
7/10/1997	KEDC	\$150,000	*	0	\$7,500	\$150,000
7/10/1997	KEDC	\$40,000	*	0	0	\$40,000
7/10/1997	KEDC	\$50,000	*	0	\$2,500	\$50,000
7/10/1997	KEDC	\$50,000	*	0	\$2,500	\$50,000
7/10/1997	KEDC	\$50,000	*	0	\$2,500	\$50,000
7/11/1998	KEDC	\$180,000	*	0	\$9,000	\$180,000
7/16/1998	KEDC	\$60,000	*	0	0	\$60,000
7/16/1998	KEDC	\$135,500	*	0	\$6,775	\$135,500
6/9/1999	KEDC	\$50,000	5/1/99-6/30/99	0	\$2,500	\$50,000
6/9/1999	KEDC	\$150,000	*	0	\$7,500	\$150,000
6/9/1999	KEDC	\$125,000	*	0	\$6,250	\$125,000
6/14/1999	KEDC	\$105,000	5/15/99-6/30/99	\$34,266	\$5,000	\$70,734
6/14/1999	KEDC	\$385,000	5/15/99-6/30/99	\$7,500	\$19,250	\$377,500
7/6/1999	KEDC	\$100,000	*	0	\$5,000	\$100,000
7/9/1997	OVEC	\$169,612	*	0	\$4,940	\$169,612
6/9/1999	NKCES	\$40,000	5/1/99-6/30/99	\$2,329	\$1,900	\$37,671
6/14/1999	BRCEE	\$105,000	5/15/99-6/30/99	\$38,832	\$5,000	\$66,167
11/3/1999	BRCEE	\$20,000	10/1/97-6/30/98	\$6,347	\$600	\$13,653
6/14/1999	KVEC	\$105,000	5/15/99-6/30/99	0	\$5,000	\$105,000
6/14/1999	ETOWN IND	\$133,900	5/1/99-6/30/99	\$69,792	\$3,900	\$60,208
6/25/1999	OLDHAM CO	\$10,000	5/15/99-6/30/99	0	\$500	\$10,000
6/18/1999	OLDHAM CO	<u>\$129,000</u>	5/1/99-6/30/99	<u>0</u>	<u>\$6,450</u>	<u>\$129,000</u>
		\$2,943,012.00		\$159,066.00	\$134,565.00	\$2,780,045.00

* Transfer of funds were authorized on purchase orders instead of a MOA. No Grant Period was specified.