OFFICE OF INSPECTOR GENERAL

M E M O R A N D U M

DATE: April 5, 2004

TO: Chairman

FROM: Inspector General

SUBJECT: Report on Audit of the E-rate Program at Children's Storefront School

The Office of Inspector General (OIG) has completed an audit at Children's Storefront School (Children's), a beneficiary of the Universal Service Fund (USF). A copy of our audit report no. 02-AUD-02-04-025, entitled "Report on Audit of the E-rate Program at Children's Storefront School" is attached. The objective of this audit was to assess the beneficiary's compliance with the rules and requirements of the USF program and to identify program areas which may need improvement.

We concluded that Children's was not compliant with the requirements of the program for funding year 2000. The audit resulted in four (4) specific findings and $491,447 identified as potential fund recoveries. The potential fund recovery is 100% of the funds paid out for internal connections and internet access. The primary factor in our recommendation for 100% recovery is that Children's did not pay their non-discounted portion of the costs. However, there are potential recoveries associated with other findings, as detailed in the attached report. We recommend that the Wireline Competition Bureau direct the Universal Service Administrative Company (USAC) to recover the full amount of $491,447 disbursed on behalf of Children's in funding year 2000. In addition, we recommend that the Wireline Competition Bureau take steps to ensure that funding requests are adequately reviewed in accordance with existing program rules and implementing procedures to make certain that funding requests associated with these areas of noncompliance with program rules and regulations are not approved. Further, we recommend that the Wireline Competition Bureau review those program rules and implementing procedures governing the areas of noncompliance cited in this report to ensure that those program rules and implementing procedures are adequate to protect the interests of the fund.

We held an exit conference on February 26, 2004 with the beneficiary's representatives, and requested their comments on the results of the audit. They concurred with two of the four audit findings, did not concur with one finding, and were unable to state whether they concurred or not with the other finding. They provided a written response to the audit findings, which is included in Appendix 1 of this report.

We provided management with a copy of our draft report on March 19, 2004 and requested they provide comments on their concurrence with the findings of the audit. In a response dated March 30, 2004, the Wireline Competition Bureau (WCB) indicated that they concurred with our three audit recommendations. WCB's response is included in its entirety in Appendix 2 to this report.

If you have any questions, please contact Thomas Cline, Assistant Inspector General for Audits, at (202) 418-7890.

H Walker Feaster III

H. Walker Feaster III

Attachment

Copy furnished:

Kathy Egmont, Head of School, The Children's Storefront
George McDonald, Vice President, Schools and Libraries Division, USAC
Chief, Wireline Competition Bureau
Performance Evaluation and Records Management, FCC Office of Managing Director

FEDERAL COMMUNICATIONS COMMISSION

OFFICE OF INSPECTOR GENERAL

Report on Audit of the E-Rate Program at
Children's Storefront School

Report No. 02-AUD-02-04-025
April 5, 2004

H. Walker Feaster III
Inspector General

Thomas C. Cline
Assistant Inspector General for Audit

Joseph Paretti
Senior Auditor

Thomas D. Bennett
Assistant Inspector General – USF Oversight

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EXECUTIVE SUMMARY

On May 7, 1997, the FCC adopted a Universal Service Order implementing the Telecommunications Act of 1996. Included in this Order was the Schools and Libraries Support Mechanism of the USF (hereinafter known as the E-rate program) in which all eligible schools and libraries can receive discounts from the USF on eligible communication services ranging from 20 to 90 percent, depending on economic need and location. The OIG has designed a program of audit oversight to provide FCC management with a reasonable level of assurance that beneficiaries are complying with program rules and that program controls are adequate to prevent fraud, waste and abuse.

The OIG has completed an audit of Children's Storefront School (Children's). The objective of this audit was to assess the beneficiary's compliance with the rules and regulations of the USF program and to identify areas in which to improve the program. Children's is an independent, tuition free school located in the Harlem section of New York City. Children's teaches pre-kindergarten to 8th grade classes. Based on its application filed with the Schools and Libraries Division (SLD) of the Universal Service Administrative Company (USAC), Children's reported that it had 158 students in Funding Year (FY) 2000 and was approved and received funding at an urban discount rate of 90% for FY 2000. The period of our audit was for FY 2000 covering July 1, 2000 to June 30, 2001.

For FY 2000 Children's had an approved commitment of $512,734 of which $494,991 (representing 96.5% of the approved commitment) was approved for installation and maintenance of internal connections and Internet access. For FY 2000 SLD disbursed $491,447 for internal connections and Internet access.

The audit resulted in four (4) specific findings and $491,447 identified as potential fund recoveries. The potential fund recovery is 100% of the funds paid out for internal connections and internet access. The primary factor in our recommendation for 100% recovery is that Children's did not pay their non-discounted portion of the costs. We recommend that the Wireline Competition Bureau direct the Universal Service Administrative Company (USAC) to recover the full amount of $491,447 disbursed on behalf of Children's in funding year 2000. In addition, we recommend that the Wireline Competition Bureau take steps to ensure that funding requests are adequately reviewed in accordance with existing program rules and implementing procedures to ensure that funding requests associated with these areas of noncompliance with program rules and regulations are not approved. Further, we recommend that the Wireline Competition Bureau review those program rules and implementing procedures governing the areas of noncompliance cited in this report to ensure that those program rules and implementing procedures are adequate to protect the interests of the fund.

We held an exit conference on February 26, 2004 with the beneficiary's representatives, and requested their comments on the results of the audit. They concurred with two of the four audit findings, did not concur with one finding, and were unable to state whether they concurred or not on another finding. They provided a written response to the audit findings, which is included in Appendix 1 to this report.

We provided management with a copy of our draft report on March 19, 2004 and requested they provide comments on their concurrence with the findings of the audit. In a response dated March 30, 2004, the Wireline Competition Bureau (WCB) indicated that they concurred with our three audit recommendations. WCB's response is included in its entirety in Appendix 2 to this report.

BACKGROUND INFORMATION

In accordance with the Inspector General Act of 1978, as amended, the Office of Inspector General (OIG) at the Federal Communications Commission (FCC) has oversight responsibilities for the Universal Service Fund (USF) as a federal program of the FCC. The USF provides affordable access to specified communications services for schools, libraries, rural health care providers, low-income consumers and companies serving high-cost areas. On May 7, 1997, the FCC adopted a Universal Service Order implementing the Telecommunications Act of 1996. Included in this Order was the Schools and Libraries Funding Mechanism of the USF (hereinafter known as the E-rate program) in which all eligible schools and libraries can receive discounts from the USF on eligible communication services ranging from 20 to 90 percent, depending on economic need and location. The Universal Service Administrative Company (USAC) is responsible for administering the Fund under the direction of the FCC's Wireline Competition Bureau (WCB). The Schools and Libraries Division (SLD) of USAC administers the E-rate program.

USF discounts can be applied to three kinds of services and products:

- Telecommunication services, including basic phone service.
- Internet access.
- Internal connections, including wiring and network equipment needed to bring information directly to classrooms or library patrons.

Children's is an independent, tuition free school located in the Harlem section of New York City. Children's teaches pre-kindergarten to 8th grade classes. Based on its application filed with the Schools and Libraries Division (SLD) of the Universal Service Administrative Company (USAC), Children's reported that it had 158 students in Funding Year (FY) 2000 and was approved and received funding at an urban discount rate of 90% for FY 2000.

For FY 2000 Children's had an approved commitment of $512,734 of which $494,991 (representing 96.5% of the approved funding commitment) was approved for installation and maintenance of internal connections and Internet access. For FY 2000 SLD disbursed $491,447 for internal connections and Internet access.

AUDIT OBJECTIVES AND SCOPE

The OIG has designed a program of audit oversight to provide FCC management with a reasonable level of assurance that beneficiaries are complying with program rules and that program controls are adequate to prevent fraud, waste and abuse. The objective of this audit was to assess the beneficiary's compliance with the rules and regulations of the USF program and to identify areas in which to improve the program.

The scope of this audit was designed to test beneficiary compliance with program requirements contained in Title 47, Part 54 of the Code of Federal Regulations (47 CFR 54.500 through 47 CFR 54.520) which provide that:

- The beneficiary determines its discount percentage by the percentage of their student enrollment that is eligible for a free or reduced price lunch under the national school lunch program or a federally-approved alternative mechanism.
- A process has been established to select the most cost effective service provider.
- Equipment and services are purchased in accordance with applicable procurement rules and regulations, and the applicant has paid its portion of the pre-discounted costs.
- Services rendered are consistent with what the beneficiary presented on its application for E-rate funds and were installed or provided before the installation deadline.
- The beneficiary has adequate resources, as certified, to use the discounted service for which funding has been provided.
- The beneficiary has an approved technology plan, as certified.

The period of our audit was for FY 2000 covering July 1, 2000 to June 30, 2001.

This audit was conducted in accordance with Government Auditing Standards issued by the Comptroller General of the United States. As part of the scope of our audit, we obtained an understanding of the specific management controls relevant to the E-rate program. Because of inherent limitations, a study and evaluation made for the limited purposes of our audit would not necessarily disclose all material weaknesses in the control structure. However, we identified significant management weaknesses as discussed in the Audit Results section of this report and in Finding Numbers 1 and 4.

AUDIT FINDINGS AND RECOMMENDATIONS

Our audit of the use of E-rate funds at Children's disclosed that the beneficiary was not compliant with the requirements of the program for funding year 2000. The following findings resulted in noncompliant and/or inappropriate funding disbursements:

1. The beneficiary did not pay the non-discounted portion of the costs for internal connections and internet access.
2. The service provider billed and received payment for recurring maintenance costs that were not provided during the funding year, resulting in an overpayment of $28,014.
3. The service provider billed and received payment for internet access costs that were not provided during the funding year, resulting in an overpayment of $20,412.
4. There was no documented competitive bidding process.

Additionally, we have reported as an Other Matter that the system we observed at Children's appeared to be underutilized.

AUDIT FINDINGS

Finding 1 of 4 - Children's Failed to Pay the Non-discounted Portion of E-rate Costs for Internal Connections and Internet Access.

Children's provided several documents to support their payment of the non-discounted portion of the costs of internal connections and internet access; however, our auditors did not find the information to be reliable. Initially, Children's offered a letter from the Gilder Foundation, a private foundation that provides funds for libraries at private schools that described a pledge of $58,000 for a library project. However, a representative of the Gilder Foundation informed us that they only fund libraries and would not make a grant in support of an E-rate project. Children's subsequently provided copies of two checks to support payment of their share. These checks were written against an account in the names of an unpaid consultant assisting Children's in their E-rate application process and an unknown party and signed by the consultant. Both checks were dated September 28, 2001; one was in the amount of $52,731 and the other was in the amount of $2,268. The checks were payable to Connect2 Internet, the service provider and both had a memo notation "Donation to Children's Store Front School for E-rate".

We noted that, while the checks were stamped "For Deposit Only" to Connect2's account and a copy of a deposit slip was provided, the checks were missing certain marks that would indicate they had been cleared by the bank that held the account. We were unable to contact either of the parties named on the checks to discuss these checks, but we are not convinced that they support payment of Children's portion of the E-rate costs. Further, we do not believe that, had these checks been written and cashed for the purposes purported, they would constitute adequate payment by Children's of the non-discounted portion.

The FCC, in Universal Service Order CC Docket 96-45 (FCC97-157,) stated that requiring applicants to pay their share would ensure efficiency and accountability in the program. Paragraph 493 of the Order states:

> Requiring schools and libraries to pay a share of the cost should encourage them to avoid unnecessary and wasteful expenditures because they will be unlikely to commit their own funds for purchases they cannot use effectively. A percentage discount also encourages schools and libraries to seek the best pre-discount price and to make informed, knowledgeable choices among their options, thereby building in effective fiscal constraints on the account fund.

Children's' failure to account and pay for its share of the non-discounted portion of E-rate services as certified on Form 471 Service Ordered and Certification Form, Block 6, Item 22, is not in compliance with program rules and requirements.

In response to the exit conference, Children's stated they were unable to state whether they concurred with this finding or not. They believed that payment of their share had been made.

We have been advised by the Wireline Competition Bureau that a beneficiary's failure to pay the non-discounted portion of E-rate costs is a rule violation that supports full recovery of funds disbursed.

<u>Finding 2 of 4 - The Service Provider Billed for Recurring Maintenance Services That Were Not Provided.</u>

For FY 2000, Connect 2 billed SLD for the full 12-month period for maintenance of the network and PBX phone system installed at Children's. We found that the service provider should have prorated the maintenance charges to be commensurate with the time period that these systems became operational. We were provided a copy of a report from Connect2 entitled "CAT5E & Fiber Cable Test Results" dated September 4, 2001; over a month after the funding year ended. No documentation was provided to support that the system was available prior to the date of this report. Consequently, we conclude that Connect 2 billed SLD $28,014 for maintenance services that were not provided in FY 2000.

On the FCC Form 473 (Service Provider Certification Form), the service provider certifies that charges reflected on the FCC Form 474 (Service Provider Invoice Form) will be based on bills or invoices billed to the beneficiary. Moreover, instructions to Form 474 require that the service provider provide the products and services and bill the school or library prior to submitting a FCC Form 474 to USAC/SLD. In addition, the FCC Rules in Title 47 CFR 54.507 (b) states that a funding year for purposes of the schools and libraries cap shall be the period July 1 through June 30; and Section 54.507(e) states that if schools and libraries enter into long term contracts for eligible services, the Administrator (USAC/SLD) shall only commit funds to cover the pro rata portion of such a long term contract scheduled to be delivered during the funding year for which universal service support is sought. Connect 2 over-billed SLD for 100% of the maintenance service costs as these services were not provided to Children's during FY 2000 and therefore was not in compliance with program rules and requirements. In response to the exit conference, Children's stated that Connect 2 began working on their system in the spring of 2001 and began providing maintenance services at that point. However they are not able to provide documentation to support this. Absent documentation and evidence that the system was installed and working (in lieu of being installed) prior to the date of Connect 2's test report, we do not find that Children's comments support revising our audit position.

<u>Finding 3 of 4 - The Service Provider Billed for Internet Access Services That Were Not Provided.</u>

For FY 2000, Connect 2 billed SLD for the full 12-month period for internet access at Children's. We found that the service provider should have prorated the access charges to be commensurate with the time period that these systems became operational. We were provided a copy of a report from Connect2 entitled "CAT5E & Fiber Cable Test Results" dated September 4, 2001; over a month after the funding year ended. No documentation was provided to support that the system was available prior to the date of this report. Consequently, we conclude that Connect 2 billed SLD $20,412 for internet access services that were not provided in FY 2000.

On the FCC Form 473 (Service Provider Certification Form), the service provider certifies that charges reflected on the FCC Form 474 (Service Provider Invoice Form) will be based on bills or invoices billed to the beneficiary. Moreover, instructions to Form 474 require that the service provider provide the products and services and bill the school or library prior to submitting a FCC Form 474 to USAC/SLD. In addition, the FCC Rules in Title 47 CFR 54.507 (b) states that a funding year for purposes of the schools and libraries cap shall be the period July 1 through June 30; and Section 54.507(e) states that if schools and libraries enter into long term contracts for eligible services, the Administrator (USAC/SLD) shall only commit funds to cover the pro rata portion of such a long term contract scheduled to be delivered during the funding year for which universal service support is sought. Connect 2 over-billed SLD for 100% of the internet access costs as these services were not provided to Children's during FY 2000 and therefore was not in compliance with program rules and requirements.

In response to the exit conference, Children's concurred with this finding.

<u>Finding 4 of 4 - Undocumented Competitive Bidding Process.</u>

Children's was not able to provide any evidence of a competitive bidding process. No documentation supporting the award decision for services requested on its Form 470 for FY 2000 was provided.

Title 47 CFR 54.504, Requests for Service (a) competitive bidding requirement, provides that all eligible schools, libraries and consortia including those entities shall participate in a competitive bidding process, pursuant to the requirement established in this subpart, but this requirement will not preempt state or local competitive bidding requirements. Section 54.511, Ordering Service, (a) Selecting a provider of eligible services, provides that in selecting a provider of eligible services, schools, libraries and consortia including any of those entities shall carefully consider all bids submitted and may consider relevant factors other than the pre-discounted prices submitted by providers. Children's was not able to provide documents that would support the soundness of their management of the E-rate funding or compliance with Title 47 CFR 54.504 and 511.

In response to the exit conference, Children's concurred with this finding.

<u>RECOMMENDATIONS</u>

<u>Recommendation 1 of 3</u> – We recommend that the Wireline Competition Bureau direct the Universal Service Administrative Company to recover the full amount of $491,447 disbursed for internal connections and internet access on behalf of Children's in funding year 2000.

<u>Recommendation 2 of 3</u> - We recommend that the Wireline Competition Bureau take steps to ensure that funding requests are adequately reviewed in accordance with existing program rules and implementing procedures to ensure that funding requests associated with these areas of noncompliance with program rules and regulations are not approved.

<u>Recommendation 3 of 3</u> - We recommend that the Wireline Competition Bureau review those program rules and implementing procedures governing the areas of noncompliance cited in this report to ensure that those program rules and implementing procedures are adequate to protect the interests of the fund.

<u>OTHER MATTER</u>

Children's utilization of the assets purchased with E-rate funding appears to be minimal. Three servers were purchased and installed, however, during the course of our fieldwork, only one of these servers was in operation. Connect2 installed 136 wire drops at Children's; 25 voice drops and 111 data drops. With the exception of seven drops in the computer room, none of the remaining data drops were in use at the time of our fieldwork.

We believe that the assets purchased for Children's are underutilized. Further, we note that the amount of internal connections funding disbursed and the number of students at Children's results in an average cost of approximately $3,100 per student. Our experience indicates this is an excessive level of funding.

Since this is not a rule violation we have not cited this as an audit finding. However, we do consider it to be a matter of interest and suggest that the WCB consider ways to ensure E-rate funded systems are commensurate with the needs of the school being funded. Note that Children's states they do not concur with this matter. They claim that on the day of our visit the servers were down due to a virus and that they are currently using more than 70% of their wire drops. Since we have not cited this matter as an audit finding, we will not comment further other than to note that, as stated above, on the date of our field visit only seven of 111 data drops were in use.

FEDERAL COMMUNICATIONS COMMISSION

OFFICE OF INSPECTOR GENERAL

Report on Audit of the E-Rate Program at
Children's Storefront School

Report No. 02-AUD-02-04-25

APPENDIX 1 – Auditee Response

March 4, 2004

Thomas Cline
Assistant Inspector General for Audits
FCC-OIG
445 12th Street SW
Room 2 – C762
Washington DC 20554

Mr. Cline:

In response to your findings as part of the exit audit for funding year 3:

1. The matching portion was not paid. The support provided for the matching portion (two checks written by John Dodson to Connect2 which do not appear to have cleared the bank and the letter from the Gilder Foundation) is not adequate to support Childrens payment of their share. The Wireline Competition Bureau of the FCC has provided guidance which states that this is a basis for full recovery of funds disbursed.

We are unable to say whether we concur or do not. We did not pay it, but we believed it had been paid based on conversations with Connect 2 and the invoices we received showing payment had been made.

2. Maintenance costs were paid for during the funding year, but were not provided until September 2001 (based on the system test date), after the end of the funding year. We will recommend recovery of funds paid for maintenance costs.

It is our recollection that Connect 2 began work on our network in the spring of 2001, that once work had begun they did maintain the work that they had performed, coming in and fixing problems. However, we do not have documentation of those visits.

3. Internet services were paid for during the funding year, but were not provided until September 2001 (based on the system test date), after the end of the funding year. We will recommend recovery of funds paid for internet access.

We concur that there was no internet access provided until fall of 2001.

4. The competitive bidding process was inadequate. There was no documenntation to support the selection of Connect 2 as the most cost-effective and responsive bidder.

We concur.

5. The system is underutilized. Most of the 136 wire drops installed were not in use and two of the three servers were not in use during the timeframe of our field work. As this is not a rule violation, we will report it as a matter of interest rather than as an audit finding.

We do not concur. On the day of our audit, the servers were down due to a virus. We are currently using more than 70% of our wire drops, leaving room for growth, and all three servers are being used for key functions on our network. We have been able to get work completed that was interrupted by the difficulties with Connect 2 and are eager to continue to develop our technology program.

Kathy Egmont
Head of School
The Children's Storefront
212-427-8605

Kathy Egmont

FEDERAL COMMUNICATIONS COMMISSION

OFFICE OF INSPECTOR GENERAL

Report on Audit of the E-Rate Program at
Children's Storefront School

Report No. 02-AUD-02-04-25

APPENDIX 2 – Management Response

NON PUBLIC
FOR INTERNAL USE ONLY

UNITED STATES GOVERNMENT

Memorandum

DATE: April 1, 2004

TO: Inspector General

FROM: Managing Director

SUBJECT: Draft Report on Audit of E-Rate Program at Children's Storefront School

Attached is the Wireline Competition Bureau's response to the draft report on the audit of the e-rate program at Children's Storefront School. We had asked the Bureau to submit its response to you through OMD. If you have any questions or concerns please contact Jerry Cowden. Thank you.

Andy Fishel

Attachment:
Response to Draft Report on Audit of the E-rate Program at Children's Storefront School

NON-PUBLIC

Wireline Competition Bureau

MEMORANDUM

DATE: March 30, 2004

TO: Inspector General

FROM: William F. Maher, Jr. WFM
Chief, Wireline Competition Bureau

SUBJECT: Report on Audit of the E-rate Program at Children's Storefront School.

Attached please find WCB's response to the OIG's audit report on Children's Storefront School.

Children's Storefront School

Recommendation 1 of 3: recover the amount of $491,447 disbursed in funding year 2000.

Wireline Competition Bureau Response: Concur

Explanation: The OIG concludes in finding #1 that CSS did not pay for its nondiscounted share of costs associated with the provision of internet access and internal connections. We concur that the information summarized in the audit report supports a conclusion that CSS failed to pay the nondiscounted portion, and that such action is a rule violation that supports full recovery of funds disbursed. The OIG concludes in finding #2 that the service provider billed for recurring maintenance services that were not provided in FY 2000. We concur that the information summarized in the audit report supports a conclusion that the service provider billed for services not rendered. The OIG concludes in finding #3 that the service provider billed for internet access services that were not provided. We concur that the information summarized in the audit report supports a conclusion that the service provider billed for internet access services that were not provided. Because full recovery is warranted for finding #1 we do not address the methodology used to calculate the amounts identified as overpayments in findings #2 and #3.

Recommendation 2 of 3: WCB should take steps to ensure that funding requests are adequately reviewed in accordance with existing rules and implement procedures to ensure that funding requests associated with this area of noncompliance with program rules are not approved.

Wireline Competition Bureau Response: Concur

Explanation: We agree with the OIG that we should take steps to ensure that funding requests are adequately reviewed in accordance with Commission rules and USAC procedures. We will work with USAC to determine whether additional procedures are warranted to address the issues identified in the report.

Recommendation 3 of 3: WCB should review those program rules and implementing procedures governing the area of noncompliance cited to in this report to ensure that those program rules and implementing procedures are adequate to protect the interests of the fund.

Wireline Competition Bureau Response: Concur

Explanation: We agree with the OIG that we should review the existing program rules and implementing procedures governing the areas of noncompliance to ensure that program rules and implementing procedures are adequate to protect the interests of the fund. We are already taking action in this regard as discussed below.

In January 2002, based on WCB's recommendation, the Commission initiated a rulemaking to consider, among other things, measures to limit fraud, waste and abuse in the e-rate program. In April 2003, the Commission sought further comment on additional issues relating to E-rate. In December 2003, the Commission adopted an Order that adopted additional measures to limit fraud, waste and abuse and sought comment on other issues relating to E-rate.

With respect to findings #2 and 3 we note that there is no specific rule requiring beneficiaries or service providers to maintain documentation that would demonstrate that service was in fact provided. With regard to findings #2, 3 and 4 the Commission has sought comment on whether program participants should be required to retain records demonstrating rule compliance for a period of five years.