OFFICE OF INSPECTOR GENERAL

M E M O R A N D U M

DATE: December 22, 2003

TO: Chairman

FROM: Inspector General

SUBJECT: Report on Audit of the E-rate Program at St. Matthew Lutheran School

The Office of Inspector General (OIG) has completed an audit at St. Matthew Lutheran School (SMLS), a beneficiary of the Universal Service Fund (USF). A copy of our audit report no. 02-AUD-02-04-07, entitled "Report on Audit of the E-rate Program at St. Matthew Lutheran 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 SMLS was not compliant with the requirements of the program for funding years 1999 and 2000. The audit resulted in ten (10) specific findings and $55,639 identified as potential fund recoveries. However, in light of the multitude of findings and systemic noncompliance with commission rules and program requirements, we recommend that the Wireline Competition Bureau direct the Universal Service Administrative Company (USAC) to recover the full amount of $136,593 disbursed on behalf of SMLS in funding years 1999 and 2000 ($118,449 + $18,144). 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 such systemic 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 March 13, 2002 with the beneficiary's representatives, and requested their comments on the results of the audit. They generally agreed with the results of the audit, however, they did not concur that the findings indicated systemic noncompliance with program requirements.

We provided management with a copy of our draft audit report, dated November 25, 2003, and requested they provide comments on their concurrence with the findings of the audit. In a response dated December 11, 2003, the Wireline Competition Bureau (WCB) indicated that they did not fully concur with all ten of the audit findings but that they did concur with our three audit recommendations. WCB's comments and audit responses are included in the applicable sections of the report and their response is included in its entirety in the Appendix to the report.

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

Walker

H. Walker Feaster III

Attachment

Copy furnished:

Mr. Thomas Manigualt, Technical Director, St. Matthew Lutheran School
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
St. Matthew Lutheran School

Report No. 02-AUD-02-04-07
December 22, 2003

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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 St. Matthew Lutheran School (SMLS). 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. St. Matthew Lutheran School (SMLS) is a small religious/private school located in the Washington Heights Section of New York City. SMLS 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), SMLS reported that it had 116 students in FY 1999 and was approved and received funding at an urban discount rate of 90% for FY 1999 and 80% for FY 2000.The period of our audit was for Funding Year (FY) 1999 covering July 1, 1999 to June 30, 2000. However, due to numerous findings of noncompliance in FY 1999 we expanded our audit to include FY 2000 covering July 1, 2000 to June 30, 2001.

For FY 1999 SMLS had an approved commitment of $125,631 of which $118,449 or 94% was approved for installation and maintenance of internal connections and Internet access. For FY 1999 SLD disbursed $118, 449 for internal connections and Internet access. For FY 2000 SMLS had an approved commitment of $28,701 of which $18,144 or 63% was approved for Internet access. SLD disbursed $18,144 for Internet access. Funding for internal connections for FY 2000 were denied because of the E-rate funding cap which funded schools with greater than an 81% discount rate.

Our audit of the use of E-rate funds at SMLS disclosed that the beneficiary was not compliant with the requirements of the program for funding years 1999 and 2000. The audit resulted in ten (10) specific findings and in $55,639 identified as potential fund recoveries. However, in light of the multitude of findings and systemic noncompliance with commission rules and program requirements we recommend that the Wireline Competition Bureau direct USAC to recover the full amount of $136,593 disbursed on behalf of SMLS in funding years 1999 and 2000 ($118,449 + $18,144). 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 such systemic 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 March 13, 2002 with the beneficiary's representative, and requested their comments on the results of the audit. They generally agreed with the results of the audit, however; they did not concur that the findings indicated systemic noncompliance with program requirements.

We provided management with a copy of our draft audit report, dated November 25, 2003, and requested they provide comments on their concurrence with the findings of the audit. In a response dated December 11, 2003, the Wireline Competition Bureau (WCB) indicated that they did not fully concur with all ten of the audit findings but that they did concur with our three audit recommendations. WCB's comments and audit responses are included in the applicable sections of the report and their response is included in its entirety in the Appendix to the 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.

St. Matthew Lutheran School (SMLS) is a small religious/private school located in the Washington Heights Section (200 Sherman Avenue) of New York City. SMLS teaches pre-kindergarten to 8th grade classes. Based on its application filed with SLD, SMLS reported that it had 116 students in FY 1999 and was approved and received funding at an urban discount rate of 90% for FY 1999 and 80% for FY 2000.

For FY 1999 (July1, 1999 to June 30, 2000) SMLS had an approved commitment of $125,631 of which $118,449 or 94% was approved for installation and maintenance of internal connections and Internet access. For FY 1999 SLD disbursed $118, 449 for internal connections and Internet access. For FY 2000 (July 1, 2000 to June 30, 2001) SMLS had an approved commitment of $28,701 of which $18,144 or 63% was approved for Internet access. SLD disbursed $18,144 for Internet access. Funding for internal connections for FY 2000 were denied because of the E-rate funding cap which limited funding to schools with greater than an 81% discount rate.

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 Funding Year 2 (FY) covering July 1, 1999 to June 30, 2000. However, due to numerous findings of noncompliance in FY 1999 we expanded our audit to include FY 2000 covering July 1, 2000 to June 30, 2001.

SMLS is a small religious/private school located in the Washington Heights Section of New York City. SMLS teaches pre-kindergarten to 8th grade classes. Based on its application filed with SLD, SMLS reported that had 116 students in FY 1999 was approved and received funding at an urban discount rate of 90% for FY 1999 and 80% for FY 2000.

For FY 1999 SMLS had an approved commitment of $125,631 of which $118,449 or 94% was approved for installation and maintenance of internal connections and Internet access. For FY 1999 SLD disbursed $118, 449 for internal connections and Internet access. For FY 2000 SMLS had an approved commitment of $28,701 of which $18,144 or 63% was approved for Internet access. SLD disbursed $18,144 for Internet access. Funding for internal connections for FY 2000 were denied because of the E-rate funding cap which limited funding to schools with greater than an 81% discount rate.

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, 2, 3, 4, 8, 9 and 10.

AUDIT FINDINGS AND RECOMMENDATIONS

Our audit of the use of E-rate funds at SMLS disclosed that the beneficiary was not compliant with the requirements of the program for funding years 1999 and 2000. The following findings resulted in noncompliant and/or inappropriate funding disbursements:

1. The technology plan was not approved in FYs 1999 and 2000.
2. An unacceptable methodology was used to calculate the discount percentage, resulting in an overpayment of $13,161.
3. The beneficiary did not budget for the non-discounted portion of the costs.
4. The beneficiary did not pay the non-discounted portion of the costs.
5. The service provider billed for T-1 internet access but provided less functional integrated services digital network (ISDN) services, resulting in an overpayment of $30,642.
6. Other unauthorized changes were made to the approved system, resulting in a system with less functionality and payments of $8,631 for assets purchased and not installed.
7. The service provider billed for recurring maintenance costs that were not provided resulting in an overpayment of $3,205.
8. Contracts with the service provider were signed prior to the allowable date.
9. There was no documented competitive bidding process.

10. The beneficiary did not have adequate resources to effectively utilize the services provided.

Management response: We concur with the OIG that full recovery of funds – a total of $136,593 – is warranted. We do not concur with the OIG's conclusion that the findings identified only $55,639 in potential fund recoveries. In WCB's view, findings 1 (lack of an approved technology plan), 3 (failure to budget the non-discounted portion), 4 (failure to pay the non-discount portion) and 8 (contract signed before the allowable contract date) are rule violations that support full recovery.

Auditor comments: We have concluded that $55,639 in potential fund recoveries were identified, but we recommended full recovery of the $136,593 disbursed. Note that in findings one and eight we state that these findings by themselves indicate that the funds were inappropriately disbursed and should be fully recovered. The $55,639 represents the dollar amounts associated with findings for which we were able to monetize the specific cost impact.

AUDIT FINDINGS

Finding 1 of 10 - SMLS Did Not Have an Approved Technology Plan for FY 1999 and FY 2000.

No technology plan was filed by SMLS for FY 1999. The FCC Form 486 (Receipt of Service Confirmation Form) filed by SMLS on February 20, 2000, for the Funding Request Numbers (FRNs) approved for internal connections and Internet access for FY 1999, shows that the SMLS Assistant Treasurer and E-rate Coordinator certified that approval had been obtained for the technology plan from "New York City Board of Education". The New York City Board of Education is not authorized by SLD to approve E-rate technology plans. For FY 2000, SMLS filed the FCC Form 486 for Internet access on December 5, 2000 and certified that the technology plan was approved by "The State Education Dept/University of the State of N.Y." SMLS filed its technology plan on April 20, 2001 with the New York State Education Department (NYSED) Office of Technology Policy, a qualified technology plan approver. The plan was approved on May 3, 2001, two months before the end of FY 2000. Based on the SLD guidelines SMLS was qualified to receive funding for Internet access for May though June 2001 only.

Title 47 CFR 54.504(b)(2)(vii), states that to ensure schools and libraries are prepared to use the requested services effectively under the E-rate program, applicants must certify that their requests are based on approved technology plans. Instructions to Form 486 requires that the beneficiary requesting funds for internal connections or Internet access certify that it has a technology plan approved by an authorized approver. SLD relied on SMLS certifications that it had an approved technology plan to effectively use the internal connections and Internet access services on Form 486. Consequently, SLD disbursed funds on these funding requests in the amount $118,449 for FY 1999 and

$18,144 for FY 2000. This finding by itself indicates that the $136,593 was inappropriately distributed and should be recovered.

Finding 2 of 10 - Unacceptable Alternative Mechanism Used to Support the E-rate Discount Percentage.

SMLS used an unacceptable alternative mechanism to support the calculated E-rate discount rate certified on Block 4 of Form 471 Services Ordered for FY 1999. This mechanism was based on a study by population size and estimated income data through November 2000 for the zip code of SMLS' location. The study was prepared by National Decision Systems, a private consultant that provides testimonial data in court cases. SLD deems this method of projecting the number of low- income student eligibility an unacceptable alternative mechanism. The FCC in the Universal Service Order CC (Common Carrier) Docket 96-45 (FCC 97-157) stated that the national school lunch program (NSLP) based on family income is a more accurate measure of a school's level of need than a model that considers general community income. It should be noted that for FY 2000 the SLD Program Integrity Assurance (PIA) review resulted in adjusting SMLS' discount rate from 90% to 80%.

Because SMLS is small school, the NYC-BOE Division of Food Services and Transportation handles the food administration at SMLS. This NYC-BOE department imposes the same eligibility requirement for free and reduced lunch under NSLP. In addition, it performs audits of the school's reported data including student applications. Based on inquiries made, NYC-BOE provided 10 months of eligible and actual data for free and reduced lunch for the school year 1999-2000. Using this data we calculated the percentage of eligible for free or reduced lunch by dividing 109 (the average number of students eligible for free or reduced lunch) by 149 (the average total number students registered) and arrived at 73% (109/149) eligible for free/reduced lunch. This 73% eligibility equates to an 80% E-Rate Urban Discount Matrix in accordance with Title 47 CFR 54.505(c). Because SMLS failed to provide adequate support for the calculation of its E-rate discount reported on Form 471 Services Ordered Form, we computed the over-reimbursement adjustment using an 80% E-rate discount for FY 1999 in lieu of the 90% claimed by SMLS. SLD funded schools and libraries at the 80% discount level for FY 1999. Using the adjusted 80% discount rate, the disbursed amount should have been $105,288 ($131,610 x 80%), instead of $118,449 ($131,610 x 90%). This results in an over-payment of $13,161 ($118,449 - $105,288) for FY 1999.

Finding 3 of 10 - SMLS Failed to Budget the Non-discounted Portion of E-rate Services and Products Costs.

Our review of the SMLS budget for the fiscal year July 1999 to June 2000 revealed no funding for the 10% non-discounted portion of E-rate associated with internal connections and Internet access for FY 1999 as certified on Form 470 (Description of Services Requested and Certification Form). Section 54.504(b)(2)(v) and Form 470 require the school to certify that it has budgeted all of the necessary funding in the current funding year to pay for the non-discount portion of requested E-rate services as well as any necessary hardware or software, and to undertake the necessary staff training required to use the services effectively. Furthermore, during our physical inspection, we observed that SMLS under-utilized the E-rate equipment installed in FY 1999. As discussed in findings 6 and 10, we observed 5 hubs that were still in their original boxes. Moreover, the computers in many of the classrooms were obsolete for LAN and Internet access making the majority of E-rate equipment and wiring underutilized. The inability to effectively utilize the assets purchased, coupled with SMLS' failure to budget and pay for its share of pre-discount E-rate and support costs (Finding 4), illustrates systemic noncompliance with program rules and requirements.

Finding 4 of 10 - SMLS Failed to Pay the Non-discounted Portion of E-rate Costs for Internal Connections and Internet Access.

Our review of the SMLS Income Statement for the period July 1999 to June 2000, provided on December 3, 2001, revealed that no amounts were shown that represented the 10% non-discounted portion of E-rate associated with internal connections and Internet access for FY 1999. After we discussed this issue with SMLS' representative, the school provided a restated Income Statement for the same period that reflected an expense for the non-discounted portion amount of $13,161 (10% x the pre-discount amount $131,610). An inquiry of the service provider revealed that SMLS has made no payment on this outstanding amount as of January 28, 2002.

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.

SMLS' 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.

Finding 5 of 10 - The Service Provider, Connect 2, Billed for T-1 Internet Access Service but Provided Less Functional ISDN Service.

Using Verizon Communications Inc.'s (Verizon d/b/a Bell Atlantic) customer billing records, it was determined that SMLS had ISDN service only beginning on January 1, 2000 to May 14, 2001 (the disconnect date). T-1 service was not provided. However, for FY 1999, the service provider, Connect 2, was reimbursed by SLD $18,468 for T-1 service for Internet access based on SMLS' approved Form 471 funding request for a T-1 line. This amount included $1,836 ($2,040 x 90%) for the installation of a full T-1 line and a local loop line, and $16,632 ($18,480 x 90%) for 12 months of recurring service charges for a full T-1 line and local loop. In addition, for FY 2000 SLD disbursed to the service provider, Connect 2, $18,144 ($22,680 x 80%) for T-1 service representing 12 months of recurring service for Internet access.

We determined that the service provider, Connect 2, was over paid $30,642 for monthly recurring charges for ISDN service for Internet access billed at rates for a full T-1 service during FY 1999 and FY 2000. This amount consisted of $15,129 for FY 1999 and $15,313 for FY 2000. The calculation of these amounts is too voluminous for inclusion in this report, but can be made available upon request.

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 has to provide the products and services and to bill the school or library for the non-discounted portion prior to submitting a FCC Form 474 to USAC/SLD. In addition, the FCC Rules in Sec. 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-rated 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 the ISDN services based on rates for T-1 services for Internet access for FY 1999 and FY 2000 and was not in compliance with program rules and regulations.

Finding 6 of 10 - Unauthorized Product Substitutions Resulted in a Less Functional System and Payment for Equipment That Was Not Utilized.

Our physical inspection of the internal connections equipment units installed at SMLS found that the actual equipment units observed differed from those equipment units listed on the approved FCC Form 471(Services Ordered and Certification Form) Item 17 attachment (quote/contract). SLD approved and disbursed funds based on the approved Form 471 funding request numbers. Using the equipment list from the approved Form 471, we were not able to locate some of the listed equipment units. The service provider provided us with a revised contract/quote list by equipment units and pricing, and informed us that SLD had approved the product substitutions, however, they were unable to provide any documentation to support this statement. In response to our inquiries, SLD informed us it has no record of these substitutions and consequently, no approval letters were issued by SLD to SMLS and Connect 2. Because the amounts invoiced by the service provider on the FCC Form 474 (Service Provider Invoice Form) were submitted as line items in the aggregate by funding request numbers (FRNs) without any breakdowns by unit/price, SLD had no knowledge of any product substitutions and relied on the original service/equipment list attached to Item 17 of the FCC Form 471(Services Ordered and Certification Form.) and approved the disbursement to the extent that the funds requested did not exceed the committed FRN amounts. Although the overall cost remained the same, the approved original list had 26 equipment units whereas the revised equipment list has 12 units as observed; a difference of 14 units. In order for the total price to remain the same as the approved original contract, the service provider increased the wiring costs by $13,000 in the revised contract. We believe the wiring charges should have been reduced because the installation of some of the equipment and cabling in various classrooms was not done; however, we are unable to quantify the cost impact of this substitution.

The FCC in DA 01-387, released February 14, 2001, allowed for product/service substitutions and established the following conditions:

- The substituted services or products have the same functionality as the services or products contained in the original proposal.
- The substitution does not result in an increase in price.
- The substitution does not violate any contract provisions or state or local procurement laws.
- The substitution does not result in an increase in the percentage of ineligible services or functions.
- The substitution is consistent with the establishing Form 470 posting and original RFP, if any.
- The applicant should make the request for product substitution and obtain SLD approval.

While this order was not effective during the period under audit, it provides a good synopsis of matters that should be considered for contractual changes involving the stewardship of federal funds. SMLS appears to have met some of these conditions stated above for the substitutions; however, it failed to make a request for the substitution and obtain SLD approval. Additionally, given the decrease in the capacity and scope of the system installed as compared to the approved system, we are of the opinion that there was a significant reduction in functionality due to the unauthorized changes.

Of the 12 units on the premises, we observed 5 hub units that were not installed and still in their original boxes. The pre-discount price of the delivered and uninstalled 5 hub units is $5,595 (4 @ $1,039 and 1@ $1,439). The remaining 7 units consisted of hubs, a router, a Dell server, a PBX and an instant Internet box. The Bay Networks

Instant Networks Internet Box was not cabled to any working unit and was not being used. During a follow-up inspection this unit, with a pre-discount price of $3,995, was no longer where it had previously been. SMLS' representative informed us that it was the property of Connect 2 and the unit was picked-up for repair. However, this equipment was paid for with E-rate funds and it is not the property of the service provider. The total amount of hardware paid for and not connected, based on the 90% discount is $8,631 ($5,595 + $3,995 = $9,590 x 90%).

Finding 7 of 10 - The Service Provider Billed for Recurring Maintenance Services That Were Not Provided.

For FY 1999, Connect 2 billed SLD for the full 12-month period for maintenance of the local area network (LAN) and PBX phone system installed at SMLS. 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 informed by SMLS that the installation of internal connections was started in the November 1999 time frame and not operational until December 1999. Connect 2 should have prorated the maintenance charges for these internal connections. Consequently, Connect 2 has billed SLD $3,205 for maintenance services not provided in FY 1999. This amount was calculated by applying a 7/12 (the portion of the funding year that the system was operational) ratio to the contract pre-discount price for maintenance and then applying the 90% discount to the over-billed amount.

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 the maintenance service not provided to SMLS during the first 5 months of FY 1999 and therefore was not in compliance with program rules and requirements.

Finding 8 of 10 - Contracts with the Service Provider Were Signed Prior to the Contract Allowable Date.

SMLS' Form 470 (Description of Services Requested and Certification Form) was posted on March 5, 1999 on the SLD website. Therefore, the allowable contract date would not be earlier than April 2, 1999. Form 471 (Services Ordered and Certification Form) was certified by SMLS on April 2, 1999 and shows a contract awarded to Connect 2 Internet Networks, Inc (Connect 2) on April 3, 1999. However, the two contracts/quotes for internal connections and Internet access attached to the Form 471 were signed by both SMLS and Connect 2 on March 31, 1999 and April 1, 1999. These contract dates are before the contract allowable date of April 2, 1999, contrary to the mandatory 28-day waiting period pursuant to Title 47 CFR 54.504(b)(4). This finding by itself indicates that the $136,593 was inappropriately distributed and should be recovered.

Finding 9 of 10 - Undocumented Competitive Bidding Process.

SMLS was not able to provide any evidence of a competitive bidding process. No copies of bids received and documentation supporting the award decision for services requested on its Form 470 for FY 1999 were provided. SMLS' representative claimed that the school was heavily in debt and consequently, various service providers contacted the school but did not want to enter into contract with the applicant.

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. SMLS 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.

Management response: We conclude that factual support is not presented in the report to determine whether finding 9 (undocumented competitive bidding process) is a rule violation. Our rules require beneficiaries to keep the same kinds of records that they keep for other procurements. The audit process did not review or analyze the record retention policy that pertains to SMLS, and thus the failure of SMLS to have records has not demonstrated to be a rule violation based on the facts set forth in the report.

Auditor comments: WCB makes an inaccurate assumption that we did not review SMLS' record retention policy. Our audit found that SMLS does not have a record retention policy. However, we do not consider the lack of a policy to preclude a finding that inadequate supporting documentation was provided in response to audit inquiries. We do not cite SMLS for noncompliance with program rules in finding 9, we state that they were unable to support their compliance. OIG is of the opinion that, as numerous prior audits of the E-rate program have disclosed, a lack of supporting documentation is a serious issue and we will cite that lack as an audit finding when it is disclosed in the course of an audit.

Finding 10 of 10 - The Beneficiary Did Not Have Adequate Resources to Effectively Utilize the Services Provided.

Section 54.504(b)(1) Requests for Service requires the schools and libraries to certify that they have funds budgeted and approved to meet their financial obligations to pay for the "non-discounted" portion of their requested services and to pay for the other components set out in their technology plan, for each funding year. The certification requirements are intended to assure that 1) the schools will be able to use the discounts cost-effectively and 2) to assure accountability that the purchased equipment and services will be used effectively. Based on interviews of key personnel at SMLS and inspection of the school facilities and documentation examined, we determined that the internal connections provided by the service provider were underutilized and not tailored to the needs and abilities of the school for effective utilization. SMLS lacked the resources, i.e., computer hardware, and the expertise to effectively use the E-rate products and services**.** As discussed in Findings 3 and 6, we observed 5 hubs that were still their original boxes and that the Internet Box was not working. The computers in many of the classrooms were obsolete for LAN and Internet access; consequently, the wiring in-place in most of the classrooms had not been utilized in any way. Moreover, for FY 2000, SMLS had funding requests for internal connections in the amount of $219,696 that included 4 additional servers, 8 hubs and wiring deemed to be excessive and redundant for a school like SMLS in terms of lacking the resources needed to properly use e-rate services and products. These E-rate eligible items would have been funded and disbursed if SLD Program Integrity Assurance (PIA) group had not reduced SMLS' E-rate discount from 90% to 80%; SLD's Funding Priority Rules were in effect and funded schools and libraries up to 81% discount rate for internal connections in FY 2000.

In a Report and Order under CC Docket 96-45 dated June 29, 2001, the Commission established that non-recurring services (i.e., internal connections) had to be installed by September 30 after the end of a funding year. While it was issued after the period under audit, this Report and Order shows the Commission fully intended that internal connections purchased with E-rate funding be installed at the beneficiary's facilities. Further, SMLS did not have asset/inventory records to show make, model, and serial number for both E-rate equipment and the supporting equipment as required by SLD. Connect 2 provided an inventory listing of the E-rate equipment by make and serial number that was used to conduct the physical inspection. While detailed inventory records are not required by the program rules governing this program, good business practices dictate an adequate level of asset control, which SMLS did not demonstrate. This lack of control, coupled with SMLS' inability to budget and pay for the non-discounted portion of the E-rate services (Findings 3 and 4), illustrates systemic noncompliance with program rules and requirements.

Management response: We do not fully concur in the OIG's analysis in support of finding 10 (lack of adequate resources to effectively utilize the services provided). FCC rules require the applicant to demonstrate that it has adequate resources to use the services requested, but **there is no explicit rule that requires beneficiaries to use**

equipment "effectively" (emphasis added). We concur with the OIG that services must be utilized, but note that there is no current standard in the Commission's rules or Orders for determining whether services are excessive or "under utilized".

Auditor comments: In finding 10, we identify numerous examples where SMLS did not have sufficient resources to effectively utilize the funded equipment. If our issue with system utilization were based on technical diagnostics on system performance or analysis of peak versus non-peak system usage, we would agree that the current regulatory framework may not support this audit finding. However, SMLS represents an egregious and blatant example of underutilization, where the standard of utilization is whether funded assets are installed or are still sitting in their original packaging or whether end-user equipment (such as desktop computers) is available to connect to funded wiring or is not. In cases such as SMLS, OIG is of the opinion that the level of underutilization is so severe as to represent an unacceptable waste of USF assets.

RECOMMENDATIONS

Recommendation 1 of 3 – We recommend that the Wireline Competition Bureau direct the Universal Service Administrative Company to recover the full amount of $136,593 disbursed on behalf of SMLS in funding years 1999 and 2000.

Management response: We concur with the OIG that full recovery of funds – a total of $136,593 – is warranted.

Recommendation 2 of 3 - 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 such systemic noncompliance with program rules and regulations are not approved.

Management response: Concur

Recommendation 3 of 3 - 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.

Management response: Concur

FEDERAL COMMUNICATIONS COMMISSION

OFFICE OF INSPECTOR GENERAL

Report on Audit of the E-Rate Program at
St. Matthew Lutheran School

Report No. 02-AUD-02-04-07

APPENDIX – Management Response

Wireline Competition Bureau

MEMORANDUM

DATE: December 11, 2003

TO: Inspector General

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

SUBJECT: Draft Report on Audit of the E-rate Program at Saint Matthew's Lutheran School

Attached please find WCB's response to the OIG's draft audit report on Saint Matthew's Lutheran.

Saint Matthew's Lutheran School

Recommendation 1 of 3: recover the full amount of $136,593 disbursed in funding years 1999 and 2000 ($118,449 and $18,144).

Wireline Competition Bureau Response: Partially Concur

Explanation:
We concur with the OIG that full recovery of funds – a total of $136,593 -- is warranted. We do not concur with the OIG's conclusion that the findings identified only $55,639 in potential fund recoveries. In WCB's view, findings 1 (lack of an approved technology plan), 3 (failure to budget the non-discounted portion), 4 (failure to pay the non-discount portion) and 8 (contract signed before the allowable contract date) are rule violations that support full recovery. We conclude that findings number 2 (unacceptable discount calculation mechanism), 5 (billed for services not received), 6 (unauthorized service substitution), and 7 (billed for maintenance not provided) also are rule violations, but because full recovery is already warranted we do not address the methodology used to calculate the $55,639.

We conclude that factual support is not presented in the report to determine whether finding 9 (undocumented competitive bidding process) is a rule violation. Our rules require beneficiaries to keep the same kinds of records that they keep for other procurements. The audit process did not review or analyze the record retention policy that pertains to SMLS, and thus the failure of SMLS to have records has not been demonstrated to be a rule violation based on the facts set forth in the report.

We do not fully concur in the OIG's analysis in support of finding 10 (lack of adequate resources to effectively utilize the services provided). FCC rules require the applicant to demonstrate that it has adequate resources to use the services requested, but there is no explicit FCC rule that requires beneficiaries to use equipment "effectively." We concur with the OIG that services must be utilized, but note that there is no current standard in the Commission's rules or Orders for determining whether services are excessive or "under utilized."

We note that the Commission has not, to date, addressed the question of whether full recovery of funding is permissible and appropriate in situations in which the findings collectively implicate only a portion of the total funding commitment, but those findings demonstrate systematic noncompliance with FCC rules and program requirements. WCB has recommended that the Commission seek comment in the item scheduled for the December 2003 agenda meeting whether such action is appropriate. We also recommend that the Commission seek comment on the circumstances under which recovery should be directed at the beneficiary, rather than the service provider.

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 within the next ninety days 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. Most recently, WCB has circulated an Order/FNPRM scheduled for Commission consideration at the December agenda meeting. WCB has already taken specific actions in the context of the open E-rate rulemaking to review the number of the rules implicated in the findings. With regard to findings 5 & 6, we have recommended that the Commission codify USAC's service substitution procedures. With regard to finding 1, WCB has recommended that the Commission seek comment on whether the Commission should revise and strengthen its rules regarding technology plans. WCB has also recommended that the Commission seek comment on whether program participants should be required to retain records for a period of five years, which is related to the issues noted by finding 9. In relation to finding 10, we have recommended that the Commission seek comment on whether to adopt additional rules to ensure that applicants make cost-effective funding requests.

In addition, WCB is considering the other findings as part of our ongoing efforts to improve the Commission's oversight over the E-rate program and reduce the occurrences of waste, fraud and abuse.