

AUDIT REPORT

Department of Education
June 2009



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

Department of Audit
Division of State Audit



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June 30, 2009

The Honorable Phil Bredesen, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and

The Honorable Timothy K. Webb, Commissioner
Department of Education
Suite 600, Andrew Johnson Tower
Nashville, Tennessee 37243

Ladies and Gentlemen:

We have conducted a financial and compliance audit of selected programs and activities of the Department of Education for the period May 1, 2006, through June 30, 2008. We also conducted a separate special investigation of overbillings by Appalachian Education Laboratories (AEL).

We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Management of the Department of Education is responsible for establishing and maintaining effective internal control and for complying with applicable laws, regulations, and provisions of contracts and grant agreements.

Our audit disclosed a finding which is detailed in the Special Investigation section of this report. The Department of Education's management has responded to the finding; we have included the response following the finding. We will follow up the audit to examine the application of the procedures instituted because of the finding.

June 30, 2009
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We have reported other less significant matters involving the department's internal control and instances of noncompliance to the Department of Education's management in a separate letter.

Sincerely,

A handwritten signature in black ink, appearing to read "Arthur A. Hayes, Jr." with a stylized flourish at the end.

Arthur A. Hayes, Jr., CPA
Director

AAH/ddb
08/065

State of Tennessee

Audit Highlights

Comptroller of the Treasury

Division of State Audit

Financial and Compliance Audit
Department of Education
June 2009

AUDIT SCOPE

We have audited the Department of Education for the period May 1, 2006, through June 30, 2008. Our audit scope included a review of internal control and compliance with laws and regulations in the areas of petty cash bank accounts, trust funds, travel, and conferences–cash receipts. The audit was conducted in accordance with generally accepted government auditing standards. We also conducted a separate special investigation of overbillings by Appalachian Education Laboratories (AEL).

SPECIAL INVESTIGATION

Weak Internal Controls at TDOE Contributed to AEL's Improper Overbillings of \$244,815.00 for Excessive Indirect Costs

In 2007, a Department of Education vendor, Appalachian Educational Laboratories (AEL), currently named Edvantia, Inc., repaid the department \$425,745.00, which included \$244,815.00 for overbilled costs and \$180,930.00 for interest, investigative, and legal costs, after it voluntarily disclosed in February 2005 that AEL had overbilled on Exemplary Educator grants with the department and requested that the state perform its own review of the matter. The overbilled amount initially disclosed by AEL was \$198,196.00. Our review was performed in conjunction with the Office of the Attorney General and the department's internal auditors.

While conducting our review, a secondary issue emerged as to whether AEL's CEO had notified a department official in early 2004 about the overbillings and whether that official had properly relayed the full extent of the information to appropriate department management. Ultimately, AEL's attorneys and the department official agreed that AEL's CEO had called the department official about the overbilling matter in April 2004, but there was disagreement about the substance of that conversation and its duration. Similarly, the department official and her

supervisor, the department's Deputy Commissioner, agreed that the department official had promptly notified the Deputy Commissioner about the call, but, again, there was disagreement about the substance of the information conveyed. In particular, the Deputy Commissioner stated that the information he received led him to regard the matter as a typical overbilling situation, which AEL would correct through appropriate reductions in subsequent billings, and not as a misappropriation of state funds. Because these conversations occurred in private between two individuals, and without witnesses, we could not determine with certainty the exact words that were spoken between the parties. However, it is evident that the gravity of the situation was not communicated to the department's Commissioner and the information did not trigger further review by department staff. The Comptroller's Office was informed of AEL's apparent overbillings in April 2005.

The fact that the overbilling came to light through the voluntary disclosure by the vendor and was not detected through normal department review procedures for vendor invoices disclosed weaknesses in the department's controls over the vendor billing and payment processes. These weaknesses contributed to the duration and extent of the overbilling (page 6).

Financial and Compliance Audit Department of Education

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Financial and Compliance Audit Department of Education

INTRODUCTION

POST-AUDIT AUTHORITY

This is the report on the financial and compliance audit of the Department of Education. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which requires the Department of Audit to “perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller.”

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

BACKGROUND

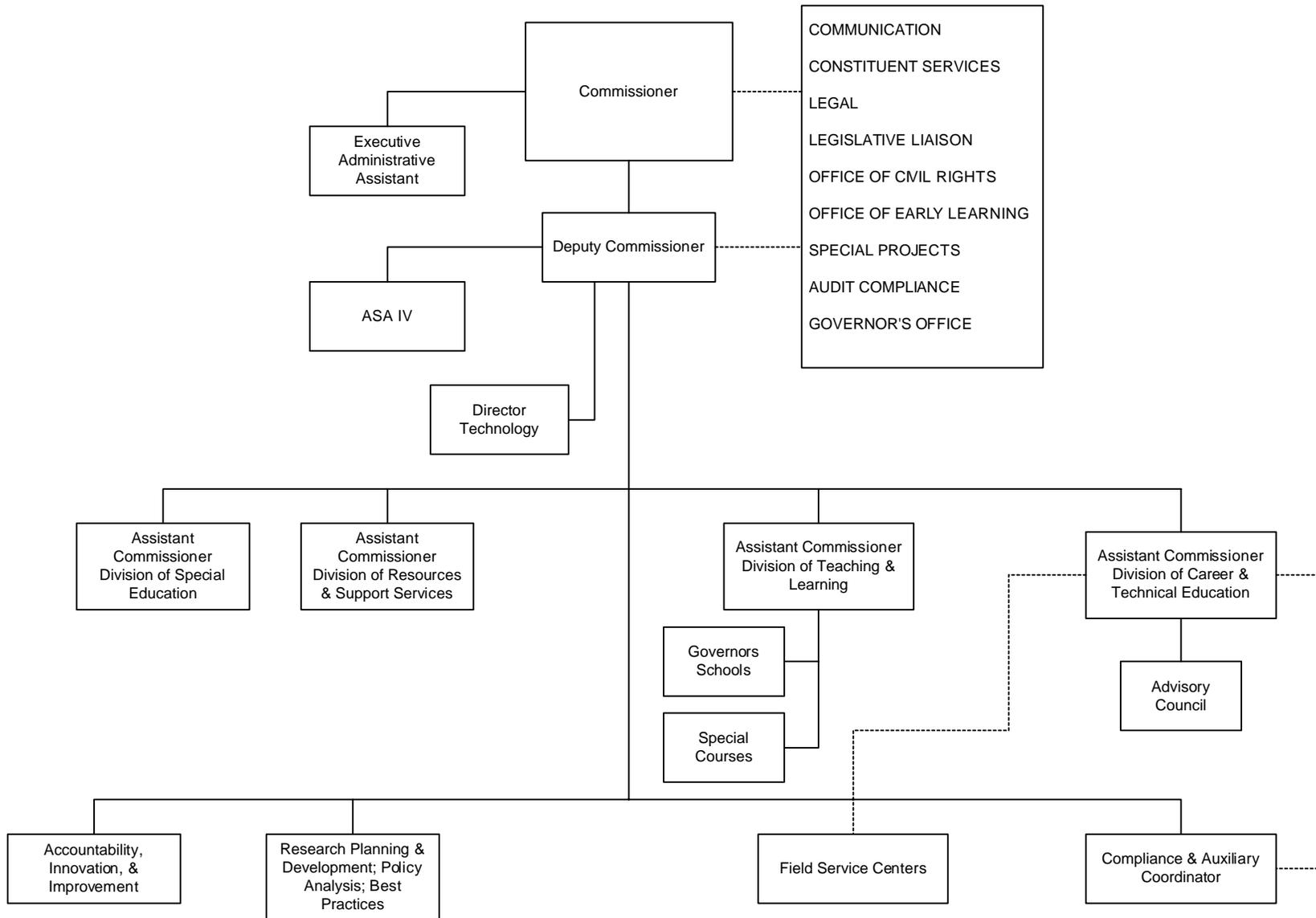
The mission of the Department of Education is to help teachers teach and children learn. It is the department’s responsibility to ensure equal, safe, and quality learning opportunities for all Tennessee students, pre-kindergarten through 12th grade. The department fulfills this mission through five major divisions: Teaching and Learning, Special Education, Career and Technical Education, Office of Early Learning, and Resources and Support Services.

Through its central office and nine field service centers, the department provides funding, technical assistance, and oversight to the 136 public school districts in Tennessee. The department provides approximately \$4,100,000,000 in state and federal flow-through funds to public school districts, which serve approximately 943,000 students and employ more than 65,000 teachers, principals, assistant principals, and supervisors of instruction. The department also provides services to approximately 575 private schools and thousands of home-schooled students across the state.

The department provides administrative support for four state special schools. These are the Alvin C. York Agricultural Institute, a model rural high school in Jamestown; the Tennessee School for the Blind in Nashville; the Tennessee School for the Deaf in Knoxville; and the West Tennessee School for the Deaf in Jackson.

An organization chart of the department is on the following page.

Department of Education Organization Chart



AUDIT SCOPE

We have audited the Department of Education for the period May 1, 2006, through June 30, 2008. Our audit scope included a review of internal control and compliance with laws and regulations in the areas of petty cash bank accounts, trust funds, travel, and conferences—cash receipts. The audit was conducted in accordance with generally accepted government auditing standards. We also conducted a separate special investigation of overbillings by Appalachian Education Laboratories (AEL).

PRIOR AUDIT FINDING

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendation in the prior audit report. The Department of Education filed its report with the Department of Audit on June 24, 2008. A follow-up of the prior audit finding was conducted as part of the current audit.

RESOLVED AUDIT FINDING

The current audit disclosed that the Department of Education has corrected the previous audit finding concerning inadequate controls over the State Board of Education’s petty cash bank account.

OBJECTIVES, METHODOLOGIES, AND CONCLUSIONS

PETTY CASH BANK ACCOUNTS

Our objectives for reviewing the petty cash bank accounts’ controls and procedures at the Tennessee School for the Blind in Nashville, the West Tennessee School for the Deaf in Jackson, and the State Board of Education in Nashville were to determine whether

- normal operations of the petty cash bank accounts (disbursements and bank statement reconciliations) were handled in accordance with the Department of Finance and Administration’s (F&A) Policy 7, “Petty Cash and Departmental Bank Accounts”; and

- reimbursements to the petty cash bank accounts were handled in accordance with F&A's Policy 7.

We interviewed key department personnel and reviewed supporting documentation to gain an understanding of the department's controls and procedures over petty cash bank accounts. We selected nonstatistical samples of disbursements and three bank statement reconciliations to determine whether these operations were handled in accordance with F&A's Policy 7. We also tested all reimbursements to the petty cash bank accounts to determine whether the reimbursements were handled in accordance with F&A's Policy 7.

Based on our testwork, we determined that normal operations of the petty cash bank accounts (disbursements and bank statement reconciliations) were handled in accordance with F&A's Policy 7, with minor exceptions relating to bank statement reconciliations; and reimbursements to the petty cash bank accounts were handled in accordance with F&A's Policy 7.

TRUST FUNDS

Our objectives for reviewing the trust funds controls and procedures at the Tennessee School for the Blind in Nashville and the West Tennessee School for the Deaf in Jackson were to determine whether

- normal operations of the trust funds (receipts, disbursements, and bank statement reconciliations) were handled in accordance with the Department of Finance and Administration's (F&A) Policy 7, "Petty Cash and Departmental Bank Accounts"; and
- interest was allocated to the various trust fund accounts in accordance with F&A's Policy 7.

We interviewed key department personnel and reviewed supporting documentation to gain an understanding of the department's controls and procedures over trust funds. We selected nonstatistical samples of receipts and disbursements and two bank statement reconciliations to determine whether these operations were handled in accordance with F&A's Policy 7. We also tested one interest allocation to determine whether the interest was allocated to the various trust fund accounts in accordance with F&A's Policy 7.

Based on our testwork, we determined that normal operations of the trust funds (receipts, disbursements, and bank statement reconciliations) were handled in accordance with F&A's Policy 7, with minor exceptions relating to receipts and bank statement reconciliations; and interest was allocated to the various trust fund accounts in accordance with F&A's Policy 7.

TRAVEL

Our objectives for reviewing travel controls and procedures were to determine whether

- travel expenditures were in compliance with the Department of Finance and Administration's (F&A) Policy 8 concerning the State of Tennessee's Comprehensive Travel Regulations; and
- travel expenditures were properly approved and appropriate.

We interviewed key department personnel and reviewed supporting documentation to gain an understanding of the department's controls and procedures over travel. We tested nonstatistical samples of paid travel expenditures to determine whether the travel expenditures were in compliance with the state's travel regulations, properly approved, and appropriate.

Based on our testwork, we determined that travel expenditures were in compliance with F&A's Policy 8, with a minor exception; and travel expenditures were properly approved and appropriate.

CONFERENCES–CASH RECEIPTS

Our objectives for reviewing conferences–cash receipts controls and procedures were to determine whether

- cash receipts were deposited promptly and intact, in accordance with the Department of Finance and Administration's (F&A) Policy 25 concerning deposit practices; and
- cash receipt transactions were properly approved and recorded.

We interviewed key department personnel and reviewed supporting documentation to gain an understanding of the department's controls and procedures over conferences–cash receipts. We tested a nonstatistical sample of conferences–cash receipts to determine whether the cash receipts were deposited promptly and intact in accordance with F&A's Policy 25, and the cash receipt transactions were properly approved and recorded.

Based on our testwork, we determined that cash receipts were deposited promptly and intact in accordance with F&A's Policy 25, and cash receipt transactions were properly approved and recorded.

FINANCIAL INTEGRITY ACT

Section 9-18-104, *Tennessee Code Annotated*, requires the head of each executive agency to conduct an evaluation of the agency's internal accounting and administrative control and

submit a report to the Commissioner of Finance and Administration and the Comptroller of the Treasury by December 31, 1999, and December 31 of every fourth year thereafter.

Our objectives were to determine whether

- the department's December 31, 2007, internal accounting and administrative control report was filed in compliance with Section 9-18-104, *Tennessee Code Annotated*;
- documentation to support the department's evaluation of its internal accounting and administrative control was properly maintained;
- procedures used in compiling information for the internal accounting and administrative control report were in accordance with the guidelines prescribed under Section 9-18-103, *Tennessee Code Annotated*; and
- corrective actions are being implemented for weaknesses identified in the report.

We interviewed key employees responsible for compiling information for the internal accounting and administrative control report to gain an understanding of the department's procedures. We also reviewed the December 31, 2007, internal accounting and administrative control report to determine whether it had been properly submitted to the Comptroller of the Treasury and the Department of Finance and Administration. We also reviewed the supporting documentation for the department's evaluation of its internal accounting and administrative control. To determine if corrective action plans had been implemented, we interviewed management and reviewed corrective action for the weaknesses identified in the report.

We determined that the Financial Integrity Act internal accounting and administrative control report was submitted on time, support for the internal accounting and administrative control report was properly maintained, and procedures used were in accordance with *Tennessee Code Annotated*. Corrective actions are being implemented for weaknesses identified in the report.

SPECIAL INVESTIGATION

OVERBILLINGS BY APPALACHIAN EDUCATION LABORATORIES (AEL)

On February 17, 2005, two attorneys from the law firm of Nixon Peabody, LLP (Nixon Peabody) and an accountant from Rubino & McGeehin Consulting Group, Inc. (Rubino & McGeehin) made a presentation in Nashville, Tennessee, to Tennessee Department of Education (TDOE) officials on behalf of their client, Appalachian Educational Laboratories, Inc. (AEL). Nixon Peabody is based in Washington, D.C., and Boston, Massachusetts, while Rubino & McGeehin is based in Bethesda, Maryland. AEL (now Edvantia, Inc.) is located in Charleston, West Virginia.

The purpose of the presentation by Nixon Peabody and Rubino & McGeehin representatives was to notify TDOE officials of AEL's overbillings related to certain Tennessee Exemplary Educators (EE) Grants, which TDOE had entered into with AEL, and AEL's purported prior notification of a TDOE official about the matter. The EE grants in question covered the period from November 2000 to June 2005.

According to its website, AEL is a 501(c)(3) nonprofit education research and development corporation that collaborates with practitioners, education agencies, publishers, and service providers to improve learning and advance student success. The EE Program provides additional support to schools in greatest need to improve student achievement, attendance, and/or graduation rates through the assignment of exemplary educators and administrators to add quality, experienced personnel to supplement existing personnel to bolster school performance. TDOE administered the EE Program through grant awards to AEL.

The two attorneys with Nixon Peabody were Mr. Jacob B. Pankowski and Mr. J. William Codinha. The accountant with Rubino & McGeehin was Mr. Edwin C. Giddings, CPA. TDOE officials present at the meeting were Dr. Lana Seivers, Commissioner; Dr. Tim Webb, Assistant Commissioner; and Ms. Christy Ballard, General Counsel.

It is important to note that, through its attorneys, AEL voluntarily brought to TDOE's attention that AEL had made certain overbilling errors in connection with the EE grant contracts.

According to the presentation on February 17, 2005, AEL improperly charged an indirect cost rate of approximately 26%. The terms of the Tennessee EE grant contracts allowed for a recovery of indirect costs of only 8%. In order to recoup a perceived 18% loss, some AEL officials had evidently "loaded" their direct costs related to some of the grants. The term "loading" describes the artificial inflation of the direct costs in order to recoup an additional 18% of indirect costs.

Dr. Terry Eidell, AEL's founder, had been the CEO until he retired. However, according to the February 17, 2005, presentation, Dr. Eidell returned as CEO on an interim basis in October 2003. Dr. Eidell subsequently discovered the loading practice in January 2004. Mr. Pankowski, Mr. Codinha, and Mr. Giddings identified a total overbilling of \$198,196.00 associated with three specific grants.

They also identified one grant in which no overbilling had occurred. In addition, they identified one grant where it appeared to them that TDOE had approved a "management fee" that provided for additional revenue to AEL. The "management fee" would enable AEL to obtain the difference between the contractually approved 8% indirect cost rate and AEL's desired 28.59% above its direct costs. However, our review of the contract documents did not identify an approved "management fee" as described in the February 17, 2005, presentation. Our review disclosed that TDOE and AEL subsequently agreed to a contract amendment that revised the indirect cost rate upwards from 8% to 28.59%. Limiting indirect costs to 8% had been a TDOE internal policy; thus, the ability to change that policy was in the hands of TDOE.

The contract amendment was signed on February 18, 2005, by Dr. Lana Seivers, Commissioner; Dr. Doris L. Redfield, then President and CEO of AEL; and Commissioner M.D. Goetz, Jr., Commissioner of the Department of Finance and Administration.

The chart below lists the grants in question:

#	Grant	Amount Overbilled	Grant Period
1	GR-01-14155-01 (Project 126)	\$ 57,541.00	11/1/2000 to 6/30/2002
2	GR-03-15071-00 (Project 136)	122,711.00	7/1/2002 to 6/30/2003
3	GR-03-15072-00 (Project 137)	17,944.00	7/1/2002 to 6/30/2003
4	GR-04-15842-00 (Projects 186-188)	no overbilling	7/1/2003 to 6/30/2004
5	GR-05-16137-01 (Projects 196 & 197)	Approved change in overhead rate	7/1/2004 to 6/30/2005
	Total	\$198,196.00	

Scope and Objectives of the Review

On April 15, 2005, Commissioner Seivers notified Mr. John Morgan, Tennessee Comptroller of the Treasury, of AEL's apparent overbilling practices. State Audit began its review immediately in conjunction with TDOE Internal Audit and the Enforcement Division of the Tennessee Attorney General's Office. Our review included interviews with relevant TDOE staff, analysis of invoices and supporting documentation maintained by TDOE, and examination of documentation and schedules provided to us by AEL through its attorneys.

The objectives of our review were

- to determine the nature and extent of AEL's overbillings in relation to the five identified grants;
- to determine the adequacy of the related internal controls at TDOE;
- to determine the nature and extent of information about AEL's overbillings communicated by AEL to TDOE;
- to report any findings to the appropriate authorities; and
- to recommend appropriate action to correct any noted deficiencies.

We reviewed 30 invoices across five grants valued at \$3,311,586.00 which were entirely state funded. AEL billed \$2,894,201.01 against the five grants. We reviewed 29 invoices across grants GR-01-14155-01, GR-03-15071-00, GR-03-15072-00, and GR-04-15842-00, and one invoice under grant GR-05-16137-01. Since grant GR-05-16137-01 was an active grant at the

onset of our review and a new indirect cost rate had been effectuated by amendment, we reviewed the one invoice for \$276,658.23 that had been submitted as of November 30, 2004.

Our review was limited to the EE grants that covered the administrative and support activities associated with the EE project as a whole. The administrative and support activities included the development and provision of training for the Exemplary Educators, collection and reporting of data, and salaries and benefits of persons providing these services.

Our review did not address grants GR-04-15888-00 and GR-05-16136-00, which encompassed the actual wages, salaries, and benefits paid to the Exemplary Educators. Those grants included a 4% indirect cost rate and were valued at \$15,729,442.00.

Overall, AEL was awarded a grand total of \$19,041,028.00 in grant dollars from November 1, 2000, through June 30, 2005. The allocation of state and federal funds during that period was \$11,624,048.00 (61%) and \$7,416,980.00 (39%), respectively.

Weak internal controls at TDOE contributed to AEL's improper overbillings of \$244,815.00 for excessive indirect costs

Finding

The ultimate result of our review was a Resolution and Settlement Agreement between AEL and the State of Tennessee. On August 20, 2007, the State of Tennessee and AEL entered into an agreement for \$425,745.00. The Governor, Comptroller, and Attorney General signed the agreement on behalf of the state, and Dr. Doris L. Redfield, AEL's President and CEO at the time, signed the agreement on behalf of AEL. At the time of the agreement, Dr. Eidell had retired from AEL for the second time.

Pursuant to the terms of the agreement, AEL committed to make three installment payments for the full amount by the end of calendar year 2007. AEL made payments of \$212,872.50, dated August 21, 2007; \$106,436.25, dated September 25, 2007; and \$106,436.25, dated December 13, 2007. The total repayment to the state was \$425,745.00, which reflected \$244,815.00 for the overbilled costs at issue as determined by our review, and \$180,930.00 for interest, investigative, and legal costs.

In the agreement, AEL represented to the state that it "desires to assure the State and the community that it intends to continue to operate in a responsible manner by ensuring appropriate and effective internal controls are in place and by training its employees in a manner that provides reasonable assurances that future billing practices will be proper."

The following schedule shows the differences between the overbillings identified by AEL and AEL's actual overbillings as determined by us.

#	Grant	Total Grant Value	Total Paid to AEL Under Grant	Overbilling per AEL	Overbilling per State Audit	Difference/ AEL v. State Audit
1	GR-01-14155-01	\$ 487,620.00	\$ 487,620.00	\$ 57,541.00	\$ 79,728.22	\$ 22,187.22
2	GR-03-15071-00	691,692.00	487,191.62	122,711.00	145,048.58	22,337.58
3	GR-03-15072-00	167,241.00	111,668.94	17,944.00	20,037.71	2,093.71
4	GR-04-15842-00	1,410,580.00	1,410,580.00	0	0	0
5	GR-05-16137-01	554,453.00	361,033.28	0	0	0
	Totals	\$3,311,586.00	\$2,858,093.84	\$198,196.00	\$244,814.51	\$46,618.51

It should be noted that Grant 05-16137-01 was an active grant at the time of the presentation by AEL's attorneys on February 17, 2005.

The principal differences in our review, compared with the representation by Nixon Peabody and Rubino & McGeehin on February 17, 2005, centered on two primary issues. First, our calculations were greater than the calculations presented by Nixon Peabody and Rubino & McGeehin because AEL had made adjustments for underbilled amounts throughout the grants for allowable charges that AEL had not billed. The representation by Nixon Peabody and Rubino & McGeehin presented these underbilled amounts as a net against the overbilled amounts, thereby reducing the total overbilled amount. We disallowed these adjustments because AEL had not billed the costs within 45 days of the end of the contract period as required by contract provisions C.5 and C.6 of the three grant contracts at issue. Second, some costs were not supported by AEL's ledger data as belonging to the time frames invoiced by AEL. We disallowed all costs outside the periods stated on the invoices.

Dr. Connie Smith, TDOE Program Staff Member Responsible for Grants

The February 17, 2005, presentation by the two Nixon Peabody attorneys and the Rubino & McGeehin accountant included the information that Dr. Eidell had informed a TDOE employee about the matter in January 2004, more than one year prior. The presentation identified the TDOE employee as Dr. Connie Smith, the Executive Director of TDOE's Office of Innovation, Improvement, and Accountability.

The following primary issues were raised by their presentation:

- a. Did Dr. Eidell tell Dr. Smith about the "loading" practice one year prior? In addition, did Dr. Smith fully and timely inform TDOE management of the matter?

- b. Did Dr. Smith tell Dr. Eidell, “Do not disclose to F&A or the public”? (“F&A” apparently referred to the Tennessee Department of Finance and Administration.)

In subsequent correspondence, Mr. Pankowski raised a third issue: Did Dr. Smith tell Dr. Eidell not to fly to Nashville to discuss the situation personally with her, as Dr. Eidell had proposed?

Mr. Pankowski later provided to us additional information that Dr. Eidell had called Dr. Smith on his cell phone, and that his call lasted half an hour. When we requested more information about Dr. Eidell’s cell phone call to Dr. Smith, Mr. Pankowski sent copies of redacted notes of interviews of AEL staff by Nixon Peabody staff. However, although we asked Mr. Pankowski specifically for Dr. Eidell’s cell phone records that presumably would evidence the exact time and date of Dr. Eidell’s cell phone call to Dr. Smith, we did not receive them because, according to Mr. Pankowski, Dr. Eidell no longer had the pertinent records.

As noted above, Mr. Pankowski stated in a letter to us that Dr. Eidell had intended to fly to Nashville, and had in fact purchased an airline ticket in order to fly to Nashville to explain AEL’s overbillings in person to Dr. Smith. We asked Mr. Pankowski for the plane ticket, or a credit card receipt used to purchase the ticket, to verify that Dr. Eidell had actually intended to come to Nashville to explain AEL’s overbillings in person to Dr. Smith. However, Mr. Pankowski informed us that neither AEL nor Mr. Eidell had a copy of the ticket. In addition, no credit card receipt was ever provided to us, although we had asked for it.

The information provided by Nixon Peabody staff raised the following concerns:

- When did Dr. Eidell talk with Dr. Smith? How long did the call last? What did Dr. Eidell tell Dr. Smith?
- Did Dr. Eidell say the words “overbilling” and “two sets of books”?
- Did Dr. Smith understand Dr. Eidell’s information, and was she surprised, shocked, and upset?
- Did Dr. Smith have prior knowledge of AEL’s overbillings?
- Did Dr. Eidell tell Dr. Smith that he intended to fly to Nashville to discuss AEL’s overbillings with her in person? Did Dr. Smith tell Dr. Eidell not to fly to Nashville to discuss the matter with her in person?
- Did Dr. Smith tell Dr. Eidell not to disclose the matter to the public or to F&A?
- Did Dr. Smith say that information about AEL’s overbillings would be harmful to the program and could kill it?

- Did Dr. Eidell tell Dr. Smith that he intended to put something in writing and send it to her? Did Dr. Smith tell Dr. Eidell that his phone call would be sufficient and that he did not need to put anything in writing?
- Did Dr. Eidell tell Dr. Smith that AEL would not bill TDOE until the overbilling matter was resolved?
- Did Dr. Eidell tell Dr. Smith the dollar amount of AEL's overbilling?
- Did Dr. Smith forward information about AEL's overbillings to anyone else in TDOE?

In our first interview with Dr. Smith, she stated that Dr. Eidell had called her in April 2004, not in January 2004, as represented by Mr. Pankowski. She stated that she believed her conversation with Dr. Eidell occurred on April 24, 2004. Dr. Smith stated that her phone billing records showed that Dr. Eidell had called her on April 24, 2004, and Dr. Smith provided us her original phone billing records that verified the call.

However, during a subsequent interview with Dr. Smith, she identified an earlier date of April 7, 2004, as the date when her phone conversation with Dr. Eidell occurred.

According to Dr. Smith, her reason for changing the date from April 24, 2004, to April 7, 2004, was that she recalled that her conversation with Dr. Eidell occurred prior to a scheduled AEL board meeting, which occurred on April 23-24, 2004, in Charleston, West Virginia. Dr. Smith identified on her phone billing records a phone call from her to Dr. Eidell that occurred on April 7, 2004. According to Dr. Smith, it was during this April 7, 2004, phone call that Dr. Eidell told her about AEL's overbillings. According to Dr. Smith, she felt certain that her conversation with Dr. Eidell occurred prior to AEL's board meeting because she recalled that, at the time of her conversation with Dr. Eidell, her primary concern was that she needed to inform Dr. Keith Brewer, TDOE's Deputy Commissioner, of the matter before he departed for AEL's April board meeting. At that time, Dr. Brewer was the TDOE Deputy Commissioner and the Commissioner's designee on AEL's board. As the Commissioner's designee, Dr. Brewer was a voting member of AEL's board, except for issues pertaining to TDOE.

In a letter to our office dated October 18, 2005, Mr. Pankowski, AEL's attorney, stated:

Apparently, Dr. Smith now admits being informed of the practice in early April. While we understand your desire to pinpoint a precise date, the point appears to now be admitted that Dr. Eidell informed Dr. Smith of the practice no later than April 7, 2004, and that her supervisors were informed.

As of July 2008, no TDOE official or employee was a member of AEL's (now Edvantia) board.

Dr. Smith's Phone Records

Dr. Smith provided us her personal cell phone records to verify the date and time of her conversation with Dr. Eidell about AEL's overbilling. We also obtained Dr. Smith's state-issued cell phone records, as well as the phone records for three TDOE landlines to which Dr. Smith had access in the offices of her and her staff. Based on our review of these phone records, we identified the following six phone calls between the five phone numbers in Tennessee and Dr. Eidell's cell phone number.

#	Date	Time	Called From	Called To	Duration (minutes)
1	April 5, 2004	4:54 P.M.	TDOE landline	Dr. Eidell's cell phone	1
2	April 7, 2004	3:34 P.M.	Dr. Smith's personal cell phone	Dr. Eidell's cell phone	2
3	April 21, 2004	10:08 A.M.	Dr. Smith's state-issued cell phone	Dr. Eidell's cell phone	2
4	April 22, 2004	4:23 P.M.	Dr. Smith's state-issued cell phone	Dr. Eidell's cell phone	1
5	April 24, 2004	5:25 P.M.	Dr. Smith's personal cell phone	Dr. Eidell's cell phone	1
6	April 24, 2004	5:50 P.M.	Dr. Eidell's cell phone	Dr. Smith's personal cell phone	6

The following aspects limited our review of relevant phone records:

- The TDOE landline call data available to us recorded only outgoing long-distance calls. The call data did not record local calls (incoming and outgoing) or incoming long-distance calls. This is because the landline phone records only showed data for billed calls, that is, outgoing long-distance calls.
- Dr. Smith's state-issued cell phone records showed the called number of outgoing phone calls only. While there was a record of incoming calls that showed the date, time, and duration of the calls, the sources of the calls (i.e., the originating phone numbers of the incoming calls) were not identified.
- Dr. Smith's personal cell phone records showed outgoing and incoming calls. While there was a record of incoming calls that showed the date, time, and duration of the calls, the sources of the calls (i.e., the originating phone numbers of the incoming calls) were not identified in all cases.

Because of the limitations of the phone records, as described above, we could not conclusively determine the history of phone calls between Dr. Eidell and Dr. Smith.

Based on our review of the limited information in the phone records for the three landlines, Dr. Smith’s state-issued cell phone, and Dr. Smith’s personal cell phone, we found no identifiable calls between Dr. Smith and Dr. Eidell for the months of January, February, or March 2004. The phone records showed that in April 2004, there were six identifiable calls between the five phone numbers in Tennessee and Dr. Eidell’s cell phone number. The first call occurred on April 5, 2004, and the last call occurred on April 24, 2004.

Information Received From AEL’s Counsel

As part of our review, we asked Mr. Pankowski to describe the contents of Dr. Eidell’s call to Dr. Smith. In response, Mr. Pankowski provided us notes of interviews conducted by Nixon Peabody staff with AEL staff. Nixon Peabody staff had redacted some sections of the interview notes, and thus not all of the interview information was available to us for our review. According to Mr. Pankowski, he provided to us the relevant portions of the interviews that pertained to the phone conversations between Dr. Eidell and Dr. Smith. The provided information contained two sets of handwritten notes that reflected what Dr. Eidell said in an interview with Nixon Peabody staff, and, in addition, a typed summary of those notes. The documents did not identify who had conducted the interviews or their positions within the Nixon Peabody organization. Mr. Pankowski further provided us a summary of Dr. Eidell’s statements by letter. Moreover, the February 17, 2005, presentation provided to TDOE a partial summary of Dr. Eidell’s recollection of his conversation with Dr. Smith.

We did not interview Dr. Eidell. We relied on representations and notes provided by AEL’s legal counsel.

The following table compares the principal statements made by Dr. Eidell, as presented in the information Mr. Pankowski provided to us, with Dr. Smith’s recollections regarding Dr. Eidell’s alleged statements.

#	Dr. Eidell	Dr. Smith
1	Dr. Eidell called Dr. Smith in January 2004, and the call lasted half an hour. AEL’s overbillings and other issues were discussed.	Dr. Eidell’s conversation with Dr. Smith occurred on April 7, 2004; and their conversation lasted about two minutes. The overbilling was the only topic discussed.
2	Dr. Eidell used the words: “overbilling” and “two sets of books” when referring to AEL’s overbillings.	Dr. Smith confirmed that Dr. Eidell said “overbilling” and “two sets of books.”

3	Dr. Smith understood his information and did not seem surprised, shocked, or upset.	Dr. Smith stated that she was shocked and upset about Dr. Eidell's information.
4	Dr. Smith appeared to already know of AEL's overbillings.	Dr. Smith stated that she did not know of AEL's overbillings until Dr. Eidell's phone call.
5	Dr. Eidell told Dr. Smith that he intended to fly to Tennessee to explain AEL's overbillings in person to Dr. Smith, but Dr. Smith told him not to fly to Nashville but to tell her about the matter over the phone.	Dr. Smith stated that Dr. Eidell did not mention anything about flying to Tennessee to explain AEL's overbilling to her in person.
6	Dr. Smith told Dr. Eidell not to go public with the overbilling and not to disclose the overbilling to F&A.	Dr. Smith denied saying not to go public or not to disclose to F&A. She stated that she told Dr. Eidell to wait until she had had an opportunity to speak about the matter with her Deputy Commissioner, which she was going to do promptly.
7	Dr. Smith indicated that if the information about the overbilling became public, the program would be killed, and that would be a shame because it had been very beneficial. Dr. Smith further stated that if the information hits the papers, we would be done, and the project would be done. It would make a mess for her.	Dr. Smith shared that she most likely expressed her view that if the information about the overbilling became public, it would hurt the program.
8	Dr. Eidell wanted to put something in writing, notifying TDOE of the AEL's overbillings. Dr. Smith told Dr. Eidell that his phone call would be sufficient and he need not put anything in writing.	Dr. Smith said that Dr. Eidell made no mention of putting something in writing.
9	Dr. Eidell told Dr. Smith that AEL would not bill TDOE until the matter was resolved. AEL would make the overbilling right.	Dr. Smith confirmed these statements.

10	Dr. Eidell did not tell Dr. Smith a dollar amount.	Dr. Smith confirmed this statement.
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Based on presently available information, Dr. Eidell told Dr. Smith that upon his return as AEL’s interim CEO, he had discovered mismanagement of finances on AEL’s part, that there were two sets of books, and that AEL had been overcharging TDOE for indirect costs. Dr. Eidell did not specify an amount to Dr. Smith. Dr. Eidell told Dr. Smith that he had uncovered the matter, that he was going to make it right, and that he was not going to charge TDOE anything until he had a handle on what AEL needed to do to fix the overcharges. Dr. Eidell asserted that he had purchased an airline ticket and that he told Dr. Smith that he intended to fly to Nashville to brief her in person about AEL’s overbillings, but that Dr. Smith directed him not to fly to Nashville. Dr. Eidell asserted that he told Dr. Smith that he intended to send a letter to Dr. Smith about AEL’s overbilling practices, but Dr. Smith told him not to write such a letter. Dr. Eidell asserted that Dr. Smith told him not to disclose the matter to the public or to F&A. Dr. Eidell also asserted that Dr. Smith did not seem surprised or shocked by his information and that she seemed to have prior knowledge of AEL’s overbillings.

According to Dr. Smith, Dr. Eidell told her that upon his return as interim AEL CEO, he had discovered mismanagement of finances on AEL’s part, that an AEL official had been maintaining two sets of books, and that apparently the AEL official had been overcharging for indirect costs not on the grant, and had been double-billing. Dr. Smith stated that Dr. Eidell named the AEL official responsible for the overbillings. Dr. Smith stated that she told Dr. Eidell that she was going to inform her supervisor, TDOE’s Deputy Commissioner, Dr. Keith Brewer, as quickly as she could.

Dr. Smith stated to us that she wanted to inform Dr. Brewer promptly because of the significance of the matter and because of the impending AEL board meeting in late April 2004, which Dr. Brewer would be attending as the Commissioner’s designee to the board. In contrast to Dr. Eidell’s account, Dr. Smith stated that Dr. Eidell did not tell her that he had purchased an airline ticket to fly to Nashville to discuss AEL’s overbillings with her in person, nor did Dr. Eidell tell her that he intended to send TDOE a letter about the matter. Dr. Smith stated that she did not tell Dr. Eidell not to fly to Nashville or not to send a letter. Dr. Smith further stated that she did not tell Dr. Eidell not to disclose the matter to the public or F&A. Contrary to Dr. Eidell’s apparent impression, Dr. Smith stated that she was shocked at Dr. Eidell’s news that AEL had been overcharging TDOE. She also stated that she had no knowledge of AEL’s overbillings until her conversation with Dr. Eidell in April 2004.

Dr. Smith stated that her conversation with Dr. Eidell lasted only a few minutes and that AEL’s overbillings of indirect costs were the only topic discussed. Dr. Smith stated that the sole purpose of their conversation was for Dr. Eidell to inform her of his discovery of AEL’s overbillings.

According to both Dr. Smith and Dr. Brewer, Dr. Smith conveyed information to Dr. Brewer about Dr. Eidell's phone call and AEL's overbillings after her phone conversation with Dr. Eidell on April 7, 2004, and before Dr. Brewer's departure to attend AEL's board meeting. The board met on April 23-24, 2004, in Charleston, West Virginia.

In our initial interview with Dr. Smith, she told us that she had met with Dr. Brewer as soon as she could in the next few days after her conversation with Dr. Eidell. Dr. Smith stated that she told Dr. Brewer that there was a problem with AEL's grants and that Dr. Eidell had called her and said that an AEL official had been keeping two sets of books. Dr. Smith stated to us that she thought she had used the words "cooking the books." Dr. Smith stated that she named the AEL official responsible. According to Dr. Smith, in response to Dr. Brewer's question about what happened, she answered that she was not sure and that she did not know the details or the particulars. Dr. Smith stated that she told Dr. Brewer that all she knew was what Dr. Eidell had told her. Dr. Smith stated that she told Dr. Brewer that Dr. Eidell had uncovered a situation where an AEL official had apparently been keeping two sets of books on TDOE's grants and there was a mismanagement of funds of some sort. Dr. Smith stated that she told Dr. Brewer that Dr. Eidell had assured her that he was going to make this right, and that AEL was not going to bill TDOE for any costs until AEL had gotten a handle on the matter. Dr. Smith stated that she told Dr. Brewer that she had asked Dr. Eidell to hold off on any discussion of the matter until she had informed Dr. Brewer. Dr. Smith stated that she told Dr. Brewer that she knew he was going to the next AEL board meeting and that she did not want him to be blind-sided about this matter at that meeting.

After our initial interview with Dr. Smith, we interviewed Dr. Brewer. Dr. Brewer's recollection of the contents of Dr. Smith's conversation with him differed from Dr. Smith's initial representations to us, in that Dr. Brewer did not recall that Dr. Smith indicated in any manner that the overbilling was due to improper acts by an AEL official. Dr. Brewer stated that Dr. Smith came to see him on an impromptu basis in either the last of March 2004 or the beginning of April 2004. According to Dr. Brewer, Dr. Smith stated to him that she had had a short two- to three-minute conversation with Dr. Eidell, and that Dr. Eidell had stated that there had been an error in bookkeeping and that there had been an overbilling. Dr. Brewer stated that he had asked Dr. Smith, "Are they going to make this correct?" and that Dr. Smith had responded, "Yes." Dr. Brewer stated that this was the extent of the conversation between himself and Dr. Smith about AEL's overbillings. Dr. Brewer stated that Dr. Smith did not say anything about two sets of books, cooking the books, or fraudulent activity. Dr. Brewer stated that Dr. Smith did not indicate any amount or time period. According to Dr. Brewer, Dr. Smith did not convey to him any information that would have raised red flags relative to AEL's billings.

Because of the differences between the recollections of Dr. Brewer and Dr. Smith about their conversation regarding possible improper acts by an AEL official, we reinterviewed Dr. Smith. In our second interview with Dr. Smith, she acknowledged that she could not say for sure that she said the words "two sets of books," "cooked the books," or "fraudulent" with reference to AEL's overbilling. According to Dr. Smith, what she could say was that she went to Dr. Brewer as soon as possible; she made him aware that Dr. Eidell had called; she told Dr. Brewer that there was a problem because AEL had overcharged TDOE; and she made Dr. Brewer aware

that Dr. Eidell was going to fix the problem. According to Dr. Smith, she told Dr. Brewer that AEL was not going to bill TDOE until AEL had corrected the problem, and that TDOE was going to be paid back for AEL's overcharge. Dr. Smith stated that she told Dr. Brewer, "Don't worry, AEL is going to correct it." Dr. Smith stated that she also told Dr. Brewer that she did not want him to be blind-sided at the upcoming AEL board meeting. When we asked Dr. Smith what message Dr. Brewer would most likely have carried away from her conversation with him, Dr. Smith responded that Dr. Brewer would have carried away the message that "it was no big deal because Terry would fix it."

Dr. Smith's apparent failure to inform Dr. Brewer, her direct supervisor, that AEL's overbillings were apparently attributable to fraudulent accounting by a former AEL official, was consistent with Dr. Smith's perspective of the matter. In our interviews with Dr. Smith, she expressed her point of view that AEL's overbillings were a "mistake" and "an unethical practice" on the part of AEL but not a fraud committed against TDOE because AEL, according to Dr. Eidell, would correct the matter, would not bill TDOE until the matter was resolved, and would ensure that TDOE was paid back. According to Dr. Smith, it was important to her that Dr. Eidell had discovered the matter, had reported the matter to TDOE, and had committed to fixing the overcharges. Dr. Smith stated that Dr. Eidell was shocked and outraged at the overcharges. Therefore, according to Dr. Smith, the problem was an internal issue for AEL and not a problem for TDOE. Dr. Smith described her mind-set as follows: "Dr. Eidell had uncovered it and disclosed it. Why should we have any doubt that he was going to fix it?"

According to Dr. Brewer, after his conversation with Dr. Smith, within the next several days to a week, when Commissioner Seivers was in the office, he told Commissioner Seivers informally in one sentence to the effect that AEL had made them aware of an overcharge and that AEL intended to correct it later. According to Dr. Brewer, Commissioner Seivers asked him, "So, they're going to correct that? No problem with the contract?" Dr. Brewer stated that he answered "Yes" to her first question and "No" to her second question. Dr. Brewer told us that he knew that he would have conveyed the following information to Commissioner Seivers: there was an overbilling problem, we are going to get the money back, they self-reported, and I do not see a problem.

Dr. Brewer explained to us that based on the information provided to him by Dr. Smith, he regarded AEL's apparent overbilling as similar in nature to other overbillings by vendors with whom he had had experience. Dr. Brewer stated that in his previous role as a school superintendent, he had had experience with vendors who had made errors in bookkeeping. According to Dr. Brewer, when such errors occurred, the vendors would make a correction on the next billing: they would reduce the next billing to compensate for the error. Dr. Brewer stated that AEL's situation appeared to conform to this pattern.

Dr. Brewer stated that in his brief discussion with Commissioner Seivers, he had not highlighted AEL's overbillings as a major issue to her because Dr. Smith had not presented it to him as a major issue, and he did not recognize it as such.

In our interview with Commissioner Seivers, she stated that she recalled being told that AEL had overcharged TDOE for EE contracts and that AEL was going to fix it. Commissioner Seivers stated that she could not recall the date of the conversation or who provided the information to her. Commissioner Seivers thought that her source could have been either Dr. Brewer or Dr. Tim Webb, then a TDOE Assistant Commissioner. According to Commissioner Seivers, the information did not send up any red flags for her relative to possible fraud, and she did not give the AEL matter another thought.

Commissioner Seivers retired from state service in February 2008. Dr. Webb served as interim TDOE Commissioner from February 2008 until his appointment as Commissioner in July 2008.

According to Dr. Brewer, when he attended the AEL board meeting in April 2004, Dr. Eidell approached him informally before the board meeting began and asked him if Dr. Smith had informed him about the bookkeeping error. Dr. Brewer stated that when he acknowledged to Dr. Eidell that Dr. Smith had in fact informed him of AEL's bookkeeping error, Dr. Eidell then stated that he wanted to alleviate any of Dr. Brewer's concerns and that AEL would correct the error. Dr. Brewer stated that he responded to Dr. Eidell that he was fine with Dr. Eidell's approach because AEL was going to correct the error. According to Dr. Brewer, he did not connect the information he had received from either Dr. Eidell or Dr. Smith to any fraudulent activity.

AEL's board met again on October 8-10, 2004. Dr. Brewer attended AEL's October 2004 board meeting as the Commissioner's designee. Dr. Brewer stated that at that board meeting, he and another Tennessee board member had been asked to leave the board meeting while the remaining members of the board discussed a matter pertaining to Tennessee. According to Dr. Brewer, the next morning, an attorney retained by AEL asked them to whom AEL should talk because the matter could be fraudulent. Dr. Brewer stated that he told the attorney that AEL should contact Commissioner Seivers.

Dr. Brewer stated that when he returned from AEL's October 2004 board meeting, he told Commissioner Seivers that AEL's attorneys wanted to set up a meeting with her. Dr. Brewer stated that he gave Mr. Pankowski's name and phone number to Commissioner Seivers at that time. Dr. Brewer further stated that he conveyed to Commissioner Seivers that he did not think there was wrongdoing on the department's part.

Dr. Seivers stated that she recalled that Dr. Brewer came back after a board meeting and said that something strange was going on because he and another Tennessee representative had been asked to step out of the board meeting but did not know why. Commissioner Seivers further stated that she recalled that an AEL attorney called directly after the AEL board meeting, and several times thereafter, to schedule an appointment with her. She stated that she asked the attorney what the purpose of the meeting was and whether he could meet with the Deputy Commissioner, but the attorney would not disclose the subject matter of the meeting, nor was he willing to meet with the Deputy Commissioner.

Neither Dr. Seivers nor Mr. Pankowski was able to confirm when the calls were made to schedule the meeting that occurred on February 17, 2005. We were unable to identify any outgoing calls from Commissioner Seivers' office to Mr. Pankowski, and the TDOE phone records did not contain any information related to incoming long distance calls. When we contacted Mr. Pankowski by phone about his records, he told us he did not have that information.

The information gathered in our review can be summarized as follows:

- Dr. Eidell stated he told Dr. Smith about AEL's overbillings in January 2004. Dr. Smith stated that Dr. Eidell did not inform her of the situation until April 2004. Dr. Smith provided us her personal cell phone records and she identified the phone call between her and Dr. Eidell. A statement subsequently issued by AEL's attorneys conceded that the phone call occurred no later than early April 2004.
- Dr. Eidell stated the telephone conversation with Dr. Smith lasted half an hour. Dr. Smith's telephone records show her calls to Dr. Eidell during April 2004 ranged from two minutes to six minutes. However, as noted, the phone records were limited and did not reflect all calls; therefore, we could not confirm the length of all phone calls.
- Dr. Eidell stated that he had purchased an airline ticket and planned to come to Tennessee to meet with Dr. Smith in person, but that Dr. Smith requested that he not do so. We requested documentation to support this claim, but AEL's attorney could not provide a ticket, a credit card receipt or statement, or any other documentation to support Dr. Eidell's claim that he had purchased an airline ticket.
- Dr. Eidell stated that Dr. Smith told him not to go public with the information, not to disclose the information to the Department of Finance and Administration, not to fly to Tennessee, and not to write a letter regarding the overbilling, and that Dr. Smith did not appear shocked by the disclosure of the overbilling. However, Dr. Smith stated that she did not tell Dr. Eidell not to go public with the information, not to disclose the information to the Department of Finance and Administration, not to fly to Tennessee, and not to write a letter regarding the overbilling, and that she was shocked by the disclosure of the overbilling.
- It can be inferred from statements attributed to Dr. Eidell that he was concerned by Dr. Smith's statements and reactions to his disclosure. However, based on statements by Dr. Brewer, when Dr. Eidell spoke with him at the AEL board meeting in late April 2004, approximately two and one-half weeks later, Dr. Eidell did not express any concern about Dr. Smith's comments, statements, or reactions when he first disclosed the overbilling to her. Instead, according to Dr. Brewer, Dr. Eidell told him he wanted to alleviate any concerns he might have regarding the matter.
- Our interviews occurred more than one year after the April 2004 phone call between Dr. Eidell and Dr. Smith, and because the conversation occurred in private between two individuals, and without witnesses, we could not determine with certainty the

exact words that were spoken between Dr. Eidell and Dr. Smith. However, Dr. Eidell and Dr. Smith were in agreement that Dr. Eidell had used the words “two sets of books” and “overbilling” when disclosing AEL’s overbilling to her; that Dr. Smith’s reaction to Dr. Eidell disclosing the overbilling included remarks about the overbilling having a negative effect on the EE program; that Dr. Eidell did not tell her a dollar amount for the overbilling; and that AEL would not bill until the situation was resolved.

- No evidence was provided to us that indicated that Dr. Smith had prior knowledge of AEL’s overbilling practices. Further, Dr. Smith denied that she had had any prior knowledge of AEL’s overbillings.
- Based on information obtained in our review, Dr. Smith timely reported the matter to her supervisor, Dr. Brewer. Dr. Smith believed she conveyed the significant points regarding the matter to Dr. Brewer. However, Dr. Brewer stated he did not recall Dr. Smith using the phrase “two sets of books” or “cooking the books” when describing the overbilling. Dr. Smith, during our first interview with her, stated she used the phrase “two sets of books” and she also thought that she used the phrase “cooking the books,” when describing the nature of the overbilling. She further stated that she conveyed to Dr. Brewer that the matter was attributable to possible misconduct by an AEL employee. However, during our second interview, Dr. Smith stated she could not say for sure whether she used the phrase “two sets of books,” “cooking the books,” or that the matter was attributable to possible misconduct by an AEL employee, although she believed she conveyed this information to Dr. Brewer.
- Our interviews occurred more than one year after the April 2004 meeting between Dr. Brewer and Dr. Smith, and because the conversation occurred in private between two individuals, and without witnesses, we could not determine with certainty the exact words that were spoken between Dr. Smith and Dr. Brewer. However, Dr. Smith and Dr. Brewer were in agreement that there was an overbilling by AEL of an unknown amount, but AEL was going to correct the problem.
- Dr. Brewer and Commissioner Seivers were in agreement that he told her that there had been an overbilling on the EE contracts, but AEL was going to fix it. Both Dr. Brewer and Commissioner Seivers stated that, based on the information they had received, they did not connect AEL’s overbilling to a possible fraud at that time.
- Dr. Brewer and Dr. Seivers were in agreement that when he returned from the October 2004 AEL Board meeting in Charleston, West Virginia, he had told her that there was an issue involving TDOE and AEL’s attorneys would be calling because they wanted to set up a meeting with her.
- A meeting among two attorneys and an accountant representing AEL, Commissioner Seivers, Assistant Commissioner Webb, and General Counsel Ballard occurred on February 17, 2005.

- Commissioner Seivers informed the Comptroller's Office about the matter on April 15, 2005.
- As a result of the analysis by State Audit and the efforts of the Enforcement Division of the Attorney General's Office, the state received \$425,745.00 in settlement from AEL, with the last payment being made on December 13, 2007.

As an organization, TDOE was notified in April 2004 that AEL had been keeping "two sets of books" on TDOE's contracts, apparently at the direction of AEL's Chief Financial Officer. An AEL attorney further informed TDOE in October 2004 that the matter could be fraudulent. Because of the potential for fraud in this situation, TDOE should have promptly notified the Office of the Comptroller. Clearly, responsible state officials have the obligation to promptly and fully disclose indications of fraud, abuse, or illegal acts to the appropriate authorities.

Two attorneys from Nixon Peabody and an accountant from Rubino & McGeehin traveled to Nashville, Tennessee, to meet with Commissioner Seivers on February 17, 2005, as previously described above. According to Commissioner Seivers, the presentation by the two Nixon Peabody attorneys and the Rubino & McGeehin accountant on February 17, 2005, caught TDOE's management completely by surprise.

Because of the nature of AEL's overbilling scheme, the scheme would have been difficult to detect without examinations of detailed information related to each direct cost category and comparisons of billed costs with project job costs as recorded in AEL's financial ledgers. As noted above, the scheme involved inflating direct costs in order to obtain an actual indirect cost rate in excess of the 8% agreed upon in the contracts. According to Dr. Smith, the principal TDOE staff member responsible for the program, neither she nor her staff reviewed AEL's invoices for mathematical accuracy, completeness, or consistency. Neither TDOE's program staff nor TDOE's fiscal staff required AEL to provide detailed information related to each direct cost category. AEL's invoices included broad categories, such as salaries, benefits, professional services, travel, meetings and conferences, and other related costs. AEL did not provide, and TDOE did not require, any further detailed documentation of costs. An example of detailed documentation of costs for the category of salaries, for instance, would include a list of salaries by individual for the period specified on the invoice. Neither program staff nor fiscal staff conducted any comparisons of billed costs with costs as recorded in AEL's financial ledgers. TDOE staff did not detect the overbillings described in this report, except for the one invoice described below, where an indirect cost rate of 26.01% was clearly shown on the invoice.

Our review included an examination of 30 AEL invoices. None of the 30 invoices provided detailed information related to any of the direct cost categories.

Policy 03 of the Department of Finance and Administration entitled "Policy 3-Uniform Reporting Requirements and Cost Allocation Plans for Subrecipients of Federal and State Grant Monies (Revised 12/97)" does not require state agencies to collect this detailed data for invoice

processing. All of the 30 invoices were in compliance with Policy 3 in that cost data was provided by program or by line item by program.

Four of the invoices did not provide cost information that would have enabled a reviewer to determine the actual direct and indirect cost amounts. These were the four invoices for the first contract, November 1, 2000, to June 30, 2002. Thus, for these four invoices, a reviewer would not have been able to calculate the indirect cost rate. Also, the second and fourth invoices for this contract period did not list cost categories for direct costs. Moreover, two additional invoices, each being the final invoice for a contract period, did not include direct and indirect cost amounts for the balance due but instead showed cumulative expenses for each cost category, total payments, and balance due. However, although the balance due amount reflected the sum of direct and indirect costs, no breakdown of those costs was provided. According to TDOE, each of these invoices would have had to have been reviewed in conjunction with prior invoices in order to determine the expenditure by cost category and indirect cost rate for the billing period.

The remaining 24 invoices did provide cost information that would have enabled a reviewer to determine direct and indirect cost amounts and to calculate the indirect cost rate. For 22 of the 24 invoices, the indirect cost rate was 8% or less. For the remaining two invoices, the indirect cost rate, as recorded on the invoice, was 26.01% for one and 28.59% for the other.

TDOE's internal auditors had selected the invoice showing an indirect cost rate of 26.01% for review. The internal auditors noted the fact that the indirect cost rate of 26.01% far exceeded the allowable indirect cost rate of 8%.

According to a memorandum from the Director of Internal Audit to the Commissioner, dated June 13, 2003, the internal auditors found "noncompliance with certain terms and conditions of a contract (GR-03-15071-00) between the department and AEL, Incorporated." The internal auditors included as an attachment to the memorandum a finding that reported their determination that AEL had overbilled a net amount of \$3,075.00 in indirect costs. According to the internal auditors, the net amount reflected adjustments to the total overbilled amount for indirect costs to reflect indirect costs that AEL could have billed but had not.

The internal auditors also noted that AEL was in noncompliance with the grant agreement because AEL had deviated from certain grant budget line items by an amount greater than 15% without TDOE's approval. The internal auditors recommended that TDOE work with AEL prior to AEL's final payment under the contract to ensure that an appropriate adjustment to the final payment was made, if needed, to correct the error.

In addition, the internal auditors recommended that TDOE ensure that AEL complied with the requirement to request prior approval before spending an amount over 15% of each line item amount agreed to in the contract budget.

In response to the internal audit finding, AEL stated that it had reconciled its accounting records and had determined that it had overbilled for contract number GR-03-15701-00 in the amount of \$12,780.08 as of March 31, 2003, and had underbilled on contract number GR-03-

15072-00 in the amount of \$601.87. The net overbilled amount was \$12,178.21. According to AEL's response, it reduced its April 2003 invoices to adjust for the errors. We confirmed that the \$12,178.21 adjustment was appropriately documented on AEL's April 2003 invoice to TDOE.

In this case, TDOE's internal auditors identified and reported an instance of overbilling by AEL. TDOE's management later obtained an appropriate reduction on a subsequent AEL invoice. However, this sequence of events in 2003 was limited to invoices relating to the two contracts between TDOE and AEL that were current at that time. Thus, there was no review of the invoices relating to the one prior closed contract or the contracts that were entered into between TDOE and AEL after the 2003 internal audit review. No further review of AEL's contracts or invoices occurred until AEL, through its attorneys, notified TDOE of other overbillings in February 2005.

To have ensured greater accountability, TDOE management should have required that AEL's invoices contained sufficient detail to have allowed checking the invoices for the appropriate cost classifications and cost rate calculations.

Subsequent Remedial Actions

The previous 8% indirect cost rate that TDOE had relied upon had been a TDOE internal policy. Thus, the ability to change that policy was in the hands of TDOE.

An entity like AEL that receives direct funding from the federal government through an award, grant, or contract and desires to charge an indirect cost, negotiates an indirect cost rate annually with the federal cognizant agency assigned to the entity. A grantee's federal cognizant agency is the federal agency with the preponderance of direct funding to the grantee. TDOE is not involved in the negotiation of the indirect cost rate between AEL and its federal cognizant agency. The contracts that AEL had entered into with TDOE are independent of any negotiated indirect cost rate between AEL and its federal cognizant agency.

While TDOE is not bound to accept the negotiated indirect rate between AEL and its federal cognizant agency, TDOE may look to such an established rate as a benchmark or industry standard rate. Therefore, TDOE could have accepted and allowed the entity to use an indirect cost rate that the entity had negotiated with the federal government.

For example, after the PowerPoint presentation by AEL's attorney on February 17, 2005, the department approved an amendment to Contract GR-05-16137-01, signed February 18, 2005, that covered, on a retroactive basis, the entirety of fiscal year 2005 and changed the allowable indirect rate from 8% to 28.59%. The indirect cost rates on the successive contracts were 25.5% for fiscal year 2006; 21.8% for fiscal year 2007; 28.4% for fiscal year 2008; and 29.5% for fiscal year 2009.

Recommendations

1. TDOE staff should review all invoices received for mathematical accuracy, completeness, and consistency. TDOE staff should immediately communicate any discrepancies to the vendor and should obtain a corrected invoice before making any payments.
2. TDOE staff should recalculate all overhead rates included in vendor invoices. TDOE staff should bring to the attention of the vendor any overhead rates that are incorrectly calculated. TDOE staff should ensure that the vendor corrects identified deficiencies before making any payments.
3. TDOE staff should not accept invoices that lack sufficient detail to determine what items or services are included. Paying invoices that lack such detail greatly increases the risk that TDOE could pay for services or goods not received. A prudent business practice would be for TDOE staff to ensure that invoices are presented in an auditable format that can be reconciled with a vendor's underlying source documentation, if necessary.

Management's Comment

We concur. The department will comply with contract requirements and state accounting policy on the submission of invoices from subrecipients and vendors. The department has reemphasized to managers and supervisors the importance of carefully reviewing invoices to ensure they are complete, consistent, and mathematically correct, and to ensure indirect cost is computed correctly. The department has also reemphasized to employees the importance of fraud prevention and detection and the importance of reporting instances of fraud or possible fraud.

OBSERVATIONS AND COMMENTS

MANAGEMENT'S RESPONSIBILITY FOR RISK ASSESSMENT

Auditors and management are required to assess the risk of fraud in the operations of the entity. The risk assessment is based on a critical review of operations considering what frauds could be perpetrated in the absence of adequate controls. The auditors' risk assessment is limited to the period during which the audit is conducted and is limited to the transactions that the auditors are able to test during that period. The risk assessment by management is the primary method by which the entity is protected from fraud, waste, and abuse. Since new programs may be established at any time by management or older programs may be discontinued, that assessment is ongoing as part of the daily operations of the entity.

Risks of fraud, waste, and abuse are mitigated by effective internal controls. Management's responsibility is to design, implement, and monitor effective controls in the entity. Although internal and external auditors may include testing of controls as part of their audit procedures, these procedures are not a substitute for the ongoing monitoring required of management. After all, the auditor testing is limited and is usually targeted to test the effectiveness of particular controls. Even if controls appear to be operating effectively during the time of the auditor testing, they may be rendered ineffective the next day by management override or by other circumventions that, if left up to the auditor to detect, will not be noted until the next audit engagement and then only if the auditor tests the same transactions and controls. Furthermore, since entity staff may be seeking to avoid auditor criticisms, they may comply with the controls during the period that the auditors are on site and revert to ignoring or disregarding the control after the auditors have left the field.

The risk assessments and the actions of management in designing, implementing, and monitoring the controls should be adequately documented to provide an audit trail both for auditors and for management, in the event that there is a change in management or staff, and to maintain a record of areas that are particularly problematic. The assessment and the controls should be reviewed and approved by the head of the entity.

FRAUD CONSIDERATIONS

Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit*, promulgated by the American Institute of Certified Public Accountants requires auditors to specifically assess the risk of material misstatement of an audited entity's financial statements due to fraud. The standard also restates the obvious premise that management, not the auditors, is primarily responsible for preventing and detecting fraud in its own entity. Management's responsibility is fulfilled in part when it takes appropriate steps to assess the risk of fraud within the entity and to implement adequate internal controls to address the results of those risk assessments.

During our audit, we discussed these responsibilities with management and how management might approach meeting them. We also increased the breadth and depth of our inquiries of management and others in the entity as we deemed appropriate. We obtained formal assurances from top management that management had reviewed the entity's policies and procedures to ensure that they are properly designed to prevent and detect fraud and that management had made changes to the policies and procedures where appropriate. Top management further assured us that all staff had been advised to promptly alert management of all allegations of fraud, suspected fraud, or detected fraud and to be totally candid in all communications with the auditors. All levels of management assured us there were no known instances or allegations of fraud that were not disclosed to us.

TITLE VI OF THE CIVIL RIGHTS ACT OF 1964

Section 4-21-901, *Tennessee Code Annotated*, requires each state governmental entity subject to the requirements of Title VI of the Civil Rights Act of 1964 to submit an annual Title VI compliance report and implementation plan to the Department of Audit by October 1 each year beginning with the Title VI compliance report and implementation plan due in 2007. Prior to 2007, the Title VI compliance report and implementation plan was due by June 30 each year. The Department of Education filed its compliance reports and implementation plans on June 30, 2007, and June 20, 2006.

Title VI of the Civil Rights Act of 1964 is a federal law. The act requires all state agencies receiving federal money to develop and implement plans to ensure that no person shall, on the grounds of race, color, or origin, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any program or activity receiving federal funds. The Tennessee Title VI Compliance Commission is responsible for monitoring and enforcement of Title VI. A summary of the dates state agencies filed their annual Title VI compliance reports and implementation plans is presented in the special report *Submission of Title VI Implementation Plans*, issued annually by the Comptroller of the Treasury.

APPENDIX

ALLOTMENT CODES

- 331.01 Administration
- 331.02 Grants-in-Aid
- 331.03 ESEA No Child Left Behind
- 331.04 Technology, Infrastructure, and Support Systems
- 331.05 Training and Professional Development
- 331.06 Curriculum and Instruction
- 331.07 State Board of Education
- 331.09 Improving Schools Programs
- 331.10 Career Ladder
- 331.11 Accountability and Assessment
- 331.19 After-School Programs Special Account
- 331.22 Governor's Books from Birth Fund
- 331.25 BEP and Other LEA Support
- 331.32 Early Childhood Education
- 331.35 School Nutrition Program
- 331.36 Special Education Services
- 331.43 Driver Education
- 331.45 Career and Technical Education Programs
- 331.90 Alvin C. York Institute
- 331.91 Tennessee School for the Blind
- 331.92 Tennessee School for the Deaf
- 331.93 West Tennessee School for the Deaf
- 331.95 Tennessee Early Intervention Services
- 331.96 Governor's Institute for Science and Math
- 331.97 Major Maintenance