



EDWARD B. HATCHETT, JR.
AUDITOR OF PUBLIC ACCOUNTS

February 28, 2000

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

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

Dear Commissioner Noland:

As you have requested, this interim report informs you of findings we have made to date in our special examination of issues pertaining to the recent irregularities involving the transfer and subsequent use of KDE funds at the Kentucky Educational Development Corporation, an education cooperative. Our examination has led us to examine money transfers between KDE and another education cooperative, the Ohio Valley Educational Cooperative (OVEC).

KRS 156.017 states that KDE may contract directly with a school district cooperative for services or assistance to accomplish goals and duties of the Commissioner of Education and KDE as established under the Kentucky Education Reform Act.

KDE has interpreted this statutory language to allow for certain KDE's management level personnel services to be provided under contract by OVEC, and for OVEC to provide payroll services and payroll administration for KDE staff, who are considered to be employees of OVEC, but who are supervised and evaluated by KDE.

Since July 1, 1991, certain KDE's management level personnel have been employees of OVEC, and these employees have been paid salaries, from KDE funds, which exceed the state's salary schedule applicable to other state employees with similar classifications.

From July 1, 1991 through June 30, 1999, it was agreed in the annual memorandum of agreement between KDE and OVEC that \$37,801,998 would be paid to KDE management level personnel as OVEC employees.

In the 1999 contract between KDE and OVEC, KDE includes the following positions, which have been characterized as being KDE management level positions:

- 30 consultants
- 1 senior systems engineer
- 1 data base analyst
- 1 staff assistant

We question the managerial nature of these positions.

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

OVEC failed to withhold occupational license fees for KDE contract employees

No local occupational license fees were withheld from compensation of KDE employees on contract with OVEC.

KDE Office of Legal Services rendered an opinion on May 27, 1992 (See Attachment 1) that KDE employees on contract with OVEC were exempt from paying city occupational license fees. According to Frankfort officials, KDE did not contact the City of Frankfort to verify the accuracy of this interpretation.

The Auditor of Public Accounts (APA) conferred with City officials who concluded that this KDE legal opinion was not correct, and who further referenced a section of the Frankfort ordinance, which does not exempt employers from withholding local occupational license fees from the compensation of employees working in Frankfort.

Approximately \$400,000 is owed in delinquent occupational license fees to the City of Frankfort

A preliminary estimate of the amount of local occupational license fees, including projected penalties and interest, owing to the City of Frankfort, dating from July 1, 1991 through December 31, 1999, by KDE employees on contract to OVEC who work in Frankfort, is \$341,647. The majority of KDE employees on contract with OVEC have workstations in Frankfort; however, the workstations of 44 former employees have yet to be identified. Applying the Frankfort occupational license fee, penalty, and interest, the delinquent local occupational license fees for these employees total approximately \$72,000.

There are other known KDE employees on contract to OVEC who work in other localities where similar occupational license fees should have been withheld, but which have not been withheld, during the same 8½ year period.

City of Frankfort officials concur with our preliminary estimates of the amount owed.

OVEC should immediately withhold occupational license fees from KDE contract employees

We recommend that OVEC immediately initiate the withholding of occupational license fees from the compensation of KDE contract employees who work in those localities that impose such occupational fees.

We recommend that OVEC contact the City of Frankfort and all other localities for which occupational license fees are levied to determine the amount of delinquent taxes that should be paid.

KDE redirected \$169,612 of general funds to OVEC after the close of FY 97

KRS 45.229 requires that within 30 days of the close of a fiscal year, the state's budget units are required to return unexpended appropriated funds, less debts obligated during the previous fiscal year, to the state's general fund.

On July 9, 1997, nine days after the close of fiscal year ended June 30, 1997, KDE disbursed \$169,612 of KDE general funds appropriated to it for use during fiscal year ended June 30, 1997.

The \$169,612 was comprised of general fund moneys of the state that were appropriated by the General Assembly to the following KDE budget units for use during the 1997 fiscal year:

\$169,612 grant to OVEC was created using Budget Units appropriated from unrelated programs

Budget Unit	Balance 6/30/97	7/9/97 Transfer to OVEC	Budget Unit Ending Balance
School & Community Nutrition	120,400	120,400	0
Drop-Out Prevention	35,410	35,400	10
Prof. Dev.- Gifted & Talented Advisory Council	13,812	13,812	0

This disbursement was characterized by KDE as a grant to OVEC for the purpose of establishing 8 model teacher content area network sites, as documented in KDE's letter to OVEC dated July 8, 1997. It is unclear how model teacher content area network sites fulfill the original intent of the appropriations.

The effective approval date of this grant was stated in the July 8, 1997 letter to be July 1, 1996.

Grant expenditures were made solely at the direction of KDE officials

From July 9, 1997 until today, of the \$169,612, OVEC has deducted (a) \$4,940 as administrative fees paid to OVEC for administering the grant, and (b) a \$60,000 payment in April 1999 to The National Faculty of Atlanta, Georgia, for teacher training services performed through December 31, 1998. A KDE official directed OVEC to make the \$60,000 payment.

Neither of these two transactions appears to be for the purpose of establishing eight model teacher content area network sites.

It appears that these KDE funds were transferred from KDE accounts near the close of the 1997 fiscal year for the purpose of "parking" these funds at OVEC so that KDE would not have to lapse these funds to the state's general fund as required by KRS 45.229.

Most of this grant money remains unspent

Thirty-two months after KDE's initial grant to OVEC in July 1997, \$104,672 remains at OVEC, awaiting KDE's directive on how to disburse these funds.

KDE violated its own Management Advisory Procedures by failing to enter into a memorandum of agreement with OVEC in connection with this grant. There is no termination date associated with the grant or with the use of the grant's funds, nor were there written instructions from KDE to OVEC detailing the specifics of grant administration.

Loss of accountability heightens risk of misusing funds

The practice of transferring KDE funds as grants to OVEC and other education cooperatives, while KDE retains control over how these funds are to be expended, creates an opportunity for the state's money to be misused, and circumvents the checks and balances established within the state's financial system.

Recommendations

We recommend KDE implement the following recommendations:

Funds appropriated by the General Assembly to KDE should be expended only for the purposes of the KDE budget units to which the appropriations were made.

Appropriated funds should not be diverted for the purpose of avoiding the lapsing of funds to the state's general fund, in accordance with KRS 45.229.

A memorandum of agreement, or master agreement, should be executed between the KDE and OVEC in every instance involving a grant of funds, as required by KDE's Management Advisory Procedures.

We will continue to provide reports to you arising out of this special examination as findings develop. We wish to thank the employees of OVEC and KDE for their cooperation in the course of this examination. Please direct any questions or comments you may about any matter contained in this report to me.

Very truly yours,



Edward B. Hatchett, Jr.
Auditor of Public Accounts

EBHJr:kct



KENTUCKY DEPARTMENT OF EDUCATION
CAPITAL PLAZA TOWER - 500 MERO STREET - FRANKFORT, KENTUCKY 40601
Thomas C. Boysen, Commissioner

June 1, 1992

John Rosati, Executive Director
Ohio Valley Educational Cooperative
Suite 117A Austin Building
1939 Goldsmith Lane
Louisville, KY 40218

Dear Dr. Rosati:

Several members of the Kentucky Department of Education (KDE) management team employed by contracts with the Ohio Valley Educational Cooperative (OVEC) have been concerned about the failure of OVEC to withhold city occupational tax for those employees working in Frankfort. At the request of Dr. Robert Arvin, I asked the KDE legal staff to research the issue and provide an in-house opinion for these personnel.

Ms. Florence Huffman, legal counsel in the Office of Legal Services, has provided the enclosed opinion. You will be happy to note that she concludes that OVEC is not required to withhold the Frankfort occupational tax.

Sincerely,

Charles D. Wade, Associate Commissioner
Office of Internal Administration

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Enclosure



KENTUCKY DEPARTMENT OF EDUCATION
CAPITAL PLAZA TOWER - 500 MERO STREET - FRANKFORT, KENTUCKY 40601
Thomas C. Boysen, Commissioner

MEMORANDUM

TO: Dr. Charles Wade ✓
Dr. Robert Arvin

FROM: Florence S. Huffman, Esq. FSH
Office of Legal Services

DATE: May 27, 1992

RE: Occupational Tax Due From Employees of OVEC

I have researched the question of whether employees of the Department on contract from OVEC should have occupational license taxes withheld. The answer is no for the following reasons.

The subject of occupational license fees is addressed in Chapter 5.04 of the Ordinances of the City of Frankfort, Kentucky. Business entities operated for gain or profit are subject to payment of an annual occupational and business license fee. Furthermore, an entity, such as OVEC, which is organized and operated exclusively for educational purposes is specifically excluded from the definition of businesses liable to pay the license fee. Ord. 5.04.01.

Thus, we may conclude that OVEC is not required to withhold an occupational license fee from employees working within the limits of the City of Frankfort because it is nonprofit, was organized exclusively for educational purposes and is being operated for that purpose today. (I have attached Ord. 5.04.01, the definitional section of the ordinance, for your reference.)

FSH/jbl

5.04.010 Definitions.

The following expressions, when used in this chapter, shall have the meaning ascribed to them in this section, except where the context clearly indicates or requires a different construction:

- (1) *Director or director of finance* means the director of finance of the City of Frankfort, Kentucky;
- (2) *City* means the City of Frankfort, Kentucky;
- (3) *Business* means an enterprise, activity, profession or undertaking of any nature conducted for gain or profit, whether conducted by a self-employed person, a corporation, an association, a copartnership, or any other entity; it shall include specifically, but not exclusively, the rental of any property, real or personal, having a situs in the city, but shall not include the usual activities of a board of trade, chamber of commerce, trade association or unions; community chest funds or foundations; corporations or associations organized and operated exclusively for religious, charitable, scientific, literary, educational or fraternal purposes, where no part of the earnings, income or receipts of such units, groups or associations inures to the benefit of any private shareholder or other person;
- (4) *Association* means a partnership or any other form of unincorporated enterprise owned by two (2) or more persons;
- (5) *Corporation* means a corporation or joint stock company organized under the laws of the United States, Kentucky, another state, territory or foreign country or a dependency thereof;
- (6) *Year* means the calendar year or the fiscal year (employed by a business subject to the license tax imposed by this chapter) if the taxpayer reports for state income tax purposes on the basis of a period other than the calendar year. If, under any of the provisions of this chapter a period of less than a full year is involved, the full-year basis of computation shall be employed and the fraction of a year allocated by employing the ratio of the number of full months of tax liability to twelve (12) the number of months in a year);
- (7) *Compensation subject to the occupational license fee.*
 - (a) The license fee on an employee's "wages" includes a license fee on all payments paid of employees for employment, which would be includible as wages in accordance with the Internal Revenue Code including the following:
 1. *Salaries:* Salaries, bonuses or incentive payments earned by an individual, whether directly or through an agent:
 - a. As an officer or employee, or both, of a corporation;
 - b. As an officer or employee (as distinguished from a partner or member) of a partnership or other association;
 - c. As an employee (as distinguished from the proprietor) of a business conducted by an individual owner;