



State of South Carolina Office of the Inspector General

April 7, 2014

Honorable Nikki R. Haley, Governor
Honorable Richard Eckstrom, Comptroller
Honorable Curtis M. Loftis, Treasurer
Honorable Hugh K. Leatherman, Chairman Senate Finance Committee
Honorable W. Brian White, Chairman House of Representative Ways & Means Committee

RE: South Carolina State University 1890 Program

Dear Budget and Control Board Members,

The purpose of this letter is to provide the Budget and Control Board (BCB) Members with the results of the State Inspector General's (SIG) review of a credible whistle blower allegation that South Carolina State University (SCSU) inappropriately diverted restricted 1890 Federal Program, Public Service Activities (PSA) funds for a number of years to cover the university's operating deficit in the millions of dollars. Reporting the results in this letter is designed to meet the public need to resolve this allegation as expeditiously as feasible to facilitate state government planning to address SCSU's pending \$13 million financial request.

Executive Summary

This review confirmed the allegation that SCSU had diverted the unused annual state PSA funding within the 1890 Program (1890) since 2007 to inappropriately subsidize SCSU's cash flow and deficit problems, which aggregated, as of 2/28/14, to a total of \$6,478,866. However, the SIG did not identify any fraud. Rather, the SIG identified a pattern of mismanagement allowing this inappropriate subsidizing practice to escalate out of control masking of SCSU's financial difficulties for a number of years. This practice deprived the 1890 access to these unused state PSA funds that could have been directed toward accomplishing its mission of helping limited-resourced clients. This practice has only worsened SCSU's financial situation by allowing deficits to grow while delaying action to address structural business issues causing these deficits. Further, ending this practice will require an immediate repayment of \$6,478,866 from SCSU's current fiscal year (FY) cash flow, which was a key driver in SCSU's current fiscal crisis.

Background

The 1890, established through SCSU's status as a land-grant institution, is a federal program funded with federal PSA dollars and matching state PSA funds. The 1890 operates as a separately funded entity from SCSU, has its own budget, and submits its own annual accountability report to the General Assembly. SCSU performs administrative functions for the 1890, such as accounting, payroll, and federal contract reporting.

The 1890 uses federal and state PSA funds to conduct research projects and provide extension services to counties throughout the state. Areas of focus include agriculture and production systems; youth and family development; 4-H youth development; adult leadership and community development; small farm assistance; environment and natural resources; technology and data management; and nutrition, food safety, and wellness. Research projects and extension outreach help limited-resource clients improve their level and quality of living and achieve their goals through wise resource management.

To provide perspective on the PSA funding administered by SCSU, Table 1 below depicts the PSA funds, including both federal and state funding, over the most recent five fiscal years (FY):

Table 1: PSA Funding Sources for Period FY 09-10 through FY 13-14

Funding Sources	FY 09-10	FY10-11	FY11-12	FY12-13	FY13-14	Total Funds	% of Total Funds
State	\$2,559,686	\$2,076,870	\$2,021,862	\$2,313,880	\$3,020,244	\$11,992,542	37%
Federal	\$3,724,297	\$4,455,761	\$4,052,176	\$4,050,242	\$3,750,046	\$20,032,522	63%
Total	\$6,283,983	\$6,532,631	\$6,074,038	\$6,364,122	\$6,770,290	\$32,025,064	100%

The federal 1890 program required a 100% state PSA fund match. However, SCSU obtained federal waivers for an approximate 60% match (\$11,992,542/\$20,032,522) over this five FY period. The federal funds, also known as "formula funds," were disbursed to the SCSU using a reimbursement model, which required SCSU to first expend its general operating funds and only then submit for reimbursement to the federal government. The budgeted federal funds, as well as the corresponding accounting, were maintained at the federal level by the Department of Agriculture. The SIG tested these 1890 federal expenditures and all sampled items were considered reasonable expenses without irregularities.

The annual state PSA matching funds were appropriated by the state legislature as a line item budget amount, which, due to its matching nature to the federal grant, were restricted to only authorized 1890 expenditures. The state matching funds were initially maintained by the Budget and Control Board. SCSU drew down these state PSA funds each year, often in two large increments, into SCSU's general operating cash account, also known as the Educational & General Account, and appropriately credited the 1890 ownership through a "Claim on Cash" accounting entry. Then, as the 1890 submitted bills to be paid with state PSA funds, the SCSU Finance

Department's accounting system paid the bills and reduced 1890's "Claim on Cash" in its general operating cash account by a like amount. Although SCSU Controller's Office separately tracked the 1890's state PSA fund balance, the state PSA physical cash was co-mingled in SCSU's general operating cash account. The SIG tested state PSA expenditures and all sampled items were considered reasonable expenses without irregularities, with the exception of two employees, previously identified by SCSU management, inappropriately using state PSA funds for salary. Both employees were terminated from state PSA funding through proactive SCSU management's actions.

Diversion of Unused State PSA Funds

During the period FY 06-07 through the current FY 13-14 (as of 2/28/2014), the SIG traced the state's annual matching PSA appropriations, expenditures, each FY's unused balance, and the increasing aggregated state PSA balance during the period under review, which is depicted in Table 2 below:

Table 2: State PSA Funds Activity for Period FY 06-07 to FY 13-14 (as of 2/28/2014*)

Cash Balance	FY 06 - 07	FY 07 - 08	FY 08 - 09	FY 09 - 10	FY 10 - 11	FY 11 - 12	FY 12 - 13	FY 13 - 14*	Total
1890 State Appropriations	\$2,879,778	\$3,903,938	\$3,395,792	\$2,559,686	\$2,076,870	\$2,021,862	\$2,313,880	\$3,020,244	\$22,172,050
1890 State Expenditures	\$2,423,225	\$2,978,017	\$3,036,899	\$2,246,628	\$1,840,816	\$1,798,160	\$1,067,073	\$302,366	\$15,693,184
1890 Annual Unused Balance	\$456,553	\$925,921	\$358,893	\$313,058	\$236,054	\$223,702	\$1,246,807	\$2,717,878	\$6,478,866
Aggregate of Unused Funds	\$456,553	\$1,382,474	\$1,741,367	\$2,054,425	\$2,290,479	\$2,514,180	\$3,760,988	\$6,478,866	\$6,478,866

Table 2 illustrates that each of the past eight FYs (FY 06-07 to FY 13-14) had an unused state PSA fund balance. This unused balance resided in SCSU's general operating cash account. The FY 06-07 annual unused state PSA funds of \$456,553 incrementally grew over eight FYs to a balance of \$6,478,866 on 2/28/2014. In the best light, the FY 06-07 unused state PSA funding of \$456,553 left in the SCSU's general cash fund was not initially unusual inasmuch as these funds can carry forward. As this balance increased each year, it appeared the 1890 Program Management was not tracking nor developing tangible plans on spending this increasing balance, while the SCSU Controller's Office increasingly considered these funds as a mechanism to solve recurring cash flow and deficit problems. Over time, this became an accepted recurring practice within the SCSU Controller's Office.

In 2013, this issue came to a head through inquiry from a member of the Board of Trustees, as well as the 1890 Program Management at SCSU. The 1890 Program Management recognized it had some level of prior year unused state PSA balances, but it had no idea of the amount nor length this balance had been accumulating. This led to meetings with the SCSU Controller's Office, along with SCSU's Grants & Contracts Office. During these meetings, there was initial ambiguity, to include the Controller's Office viewing these state PSA funds as unrestricted, thus not requiring repayment to 1890 of diverted funds. However, this ambiguity was clarified by a former Assistant Vice President (AVP) for Finance and Management who, in June 2013, at least

formally recognized the 2013 diversion of state PSA funds as a short term SCSU liability. Even further, this former AVP went so far as to request permission from the State Budget Division (SBD) in June 2013 to approve this transaction. The SBD approved this somewhat hurried end of FY financing maneuver, based on the lack of options and SCSU's representation this practice had been done in the past. The SBD advised SCSU to stop this practice, as well as requested an updated budget plan for the next FY to monitor this deficit situation which was never provided despite multiple inquiries.

By late 2013, a variety of official correspondence clarified 1890 funds were restricted. On 1/23/2014, SCSU General Counsel issued a legal opinion that the use of state 1890 were in fact restricted, and the funds were not authorized or permitted for any use outside of the 1890 Program (Section 1449(e) of the National Agricultural Research, Extension, and Teaching Policy Act of 1977). However, the FY 13-14 1890 state PSA funds were drawn down once more on 1/31/2014 to, again, subsidize the operating expenses of SCSU in order to process payroll for 2/1/2014.

Attachment A to this letter illustrates the impact of using the state PSA funds to subsidize SCSU's recurring cash flow and deficit problems. The unused state PSA fund balances were charted by year along with SCSU's monthly book cash balance (end of month) from June 2009 (end of FY 08-09) through 2/28/2014. During this 57 month period, SCSU's monthly book cash balance dipped below the aggregate unused state PSA funds in 31 months (54%), which demonstrated the critical need, as well as masking quality, for these state PSA funds in covering cash flow and deficit problems.

Essentially, SCSU used these state PSA funds as an interest free loan, drawn upon and repaid many times each year, which was also confirmed by SCSU's external auditor several days prior to issuance of this letter. What may have started out as a harmless, but still inappropriate, short term borrowing for cash flow turned into substantively a sizable permanent loan not formally recognized. SCSU placed itself into the awkward situation where it did not have the capacity to let 1890 use their own carry forward state PSA funds because SCSU was so dependent on these funds to be available to cover its recurring cash flow problems and deficits.

Despite SCSU's legal opinion and new policy to end this practice, the impact of stopping this practice was not initially fully recognized. During the SIG review, it organized 1890, SCSU Grants & Contracts Office, and the SCSU Controller's Office to reconcile eight years of 1890 state PSA funds, which identified 1890's unused state PSA totaling \$6,478,866. To meet the spirit of federal 1890 requirements, as well as give 1890 access to its own funds without relying on available funds in SCSU's general operating account, SCSU agreed in early April 2014 to set up a separate cash account for 1890 funds. The consequence of halting this practice will require a \$6,478,866 withdrawal from the SCSU FY 13-14 general operating cash account for this new 1890 cash account, which will negatively impact SCSU's current cash flow and is a key driver in SCSU's current fiscal crisis.

The harm of this practice to the 1890 was \$6,478,866 in unused state PSA funds, which was equivalent to three years of budgeted PSA funds, going unspent from its legislatively intended purpose for research and helping limited-resource clients improve their level and quality of living. Now that 1890 will have unfettered access to this \$6,478,866, these funds can be spent, although delayed, as legislatively appropriated.

The 1890 Program Is a Symptom of a Broader Financial Problem

SCSU's use of state PSA funds over many years resulting in the \$6,478,866 negative impact to SCSU's FY 13-14 cash flow was not the cause of SCSU's current fiscal crisis; it was only a contributor and a symptom of a broader financial problem. SCSU's current fiscal crisis has been in the making for a number of years as vividly illustrated in its external auditor's report for fiscal year end 6/30/2013 (see full external audit report at link: <http://oig.sc.gov/Documents/BDO%202013%20Audit%20Report%20on%20SCSU.pdf>). The report sets forth a "Composite Financial Index," which integrated a variety of financial factors into one index number representing the financial health of the SCSU on a scale of 0 (low) to 10 (high) [pages 28-29]. This generally accepted industry index has been dropping for the past four years, and, as of 6/30/2013, the index was a -1.64. Interviewees interpreted this -1.64 index number from a variety of perspectives, but even placed in the most positive light, it represented a serious weak financial condition.

Why SCSU management did not sufficiently act on the early warning indicators of its declining financial position over the past several years is up for debate. It was fully recognized that SCSU, during this same period of time, was dealing with many uncontrollable factors such as changes in federal student grants and loans negatively impacting students' ability to pay tuition, as well as reductions in state and federal funding. Regardless of the factors driving SCSU's declining financial position and SCSU's management response, the net result left SCSU in a weak financial position entering FY 13-14, which was further exacerbated by SCSU's FY 13-14 significant enrollment decline coupled with the unexpected 1890 liability. All these factors are driving today's fiscal crisis which is potentially undermining the university's accreditation and long-term health.

It is clear SCSU has a short-term cash infusion need to address the short-term deficit crisis, which if not, the situation could evolve into a crisis of confidence creating unintended consequences further undermining future student enrollment. It is also fairly clear, SCSU may need some level of re-investment in its core product, the university, due to operating in a fiscally restrictive environment for a number of years. SCSU is facing the dual challenge of needing a cost reduction program to tackle the expense side of its financial health equation, while simultaneously strategically investing to promote increased enrollment.

The solution to this complex business problem with a variety of short-term and long-term factors is to build a seamless partnership between SCSU and state government. The appropriate partnership mechanism can vary. Such a mechanism is needed to provide assurances to taxpayers that the underlying structural business issues causing the recurring deficits are

addressed, while also support SCSU leadership through attestation of SCSU's recovery plan and rigorous execution of this plan to regain its fiscal health and long-term success. Further, such a partnership mechanism provides a transparency capability beneficial in a high change environment to ensure the anticipated input from impacted parties, both internally and externally, is appropriately considered and balanced against the primary objectives—regain fiscal health and the long-term success of SCSU.

The SIG intends to follow this summary letter with a formal report setting forth the data to support its findings and formal recommendations. However, this letter sufficiently summarizes the 1890 state PSA fund allegation, results, and its financial impact on SCSU, as well as an overview of how 1890 is only a symptom of a broader financial problem at SCSU.

The SIG appreciates the challenging situation presented to the Budget and Control Board Members, as well as the legislature, to give thoughtful consideration to assist SCSU in a compressed timeframe to avoid a financial crisis that has the potential to undermine the confidence in the university. The SIG is available to answer any questions you may have or consider additional work to address this important, pressing issue to be solved.

Sincerely,

Patrick J. Maley
Inspector General

PM/BW

Cc: Chairman William Small Jr., Board of Trustees, SCSU
President Thomas J. Elzey, SCSU
Executive Director Marcia S. Adams, Budget and Control Board

Attachment A

South Carolina State University Monthly Cash Balance vs. State PSA Accumulated Funds Balance For Period June 2009 through February 2014

