Audit Report

St. Mary's College of Maryland

February 2010

OFFICE OF LEGISLATIVE AUDITS
DEPARTMENT OF LEGISLATIVE SERVICES
MARYLAND GENERAL ASSEMBLY

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DEPARTMENT OF LEGISLATIVE SERVICES
OFFICE OF LEGISLATIVE AUDITS
MARYLAND GENERAL ASSEMBLY

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February 16, 2010

Senator Verna L. Jones, Co-Chair, Joint Audit Committee
Delegate Steven J. DeBoy, Sr., Co-Chair, Joint Audit Committee
Members of Joint Audit Committee
Annapolis, Maryland

Ladies and Gentlemen:

We have audited the St. Mary's College of Maryland for the period beginning July 1, 2006 and ending April 12, 2009. The College is a public, liberal arts honors college that offers undergraduate and graduate degree programs in various disciplines. The College is governed by a Board of Trustees as authorized by the Education Article, Title 14, Subtitle 4.

Our audit disclosed that the College acquired a tract of undeveloped land adjacent to its campus from an individual affiliated with the College. The College paid the seller $800,000 and also accepted a nonmonetary charitable donation for $825,300 for the remainder of the land value as supported by an appraisal obtained by the seller. However, this appraisal was based on assumptions provided to the appraiser by the seller and the appraisal specifically prohibited its use by third parties. Furthermore, the College did not disclose nor present this seller's appraisal and the related donation to the Board of Public Works when the purchase was presented for approval. Rather, the College listed the purchase price as $800,000 and presented two subsequent appraisals the College had obtained that placed the value at $860,000 and $1.1 million. We have referred this matter to the Criminal Division of the Office of the Attorney General.

Our audit disclosed other deficiencies regarding the College's controls over purchases and disbursements. For example, purchase orders were frequently prepared after the related invoices were received. In addition, the College did not establish adequate procedures to monitor and control expenditures paid to its food service contractor totaling $11.6 million and funds totaling $1.2 million that were transferred to an overseas fiduciary responsible for the College's international program in Italy.

We also noted internal control weaknesses over the College's automated records and computer applications. For example, changes to student grades were not always independently verified and approved, and many system users had inappropriate access to critical applications. In addition, monitoring of security-related events was inadequate and the College's computer network did not adequately protect against internal and external threats.

Furthermore, sufficient controls were not established over cash receipts and employee paid benefits. For example, paid sabbatical leave was not always awarded and monitored in accordance with the College's policy. Finally, a formal agreement had not been executed between the College and its affiliated foundation.

An Executive Summary of our findings can be found on page 5. The response from the College to our findings and recommendations is included as an appendix to this report. We wish to acknowledge the cooperation extended to us during the course of this audit by the College.

Respectfully submitted,

Bruce A. Myers, CPA
Legislative Auditor

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* **Denotes item repeated in full or part from preceding audit report**

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Executive Summary

Legislative Audit Report on St. Mary's College of Maryland
February 2010

- **The College acquired undeveloped land adjacent to its campus from an individual affiliated with the College for $1,625,300. The College paid the seller $800,000 and accepted a nonmonetary charitable donation for $825,300 based on the seller's appraisal that specifically prohibited the use of the appraisal by third parties. In addition, the College did not disclose nor present this appraisal to the Board of Public Works (BPW) when requesting approval for the land purchase. Rather, the College listed the purchase price as $800,000 and did not disclose the $825,300 donation as part of the land acquisition. To support the purchase price, the College presented two subsequent appraisals it obtained, which valued the land at $860,000 and $1.1 million. We referred this matter to the Criminal Division of the Office of the Attorney General.**

  The College should report this appraisal and charitable donation to the BPW and should value future land transactions based on independent appraisals obtained and relied on for the purchase amount. Furthermore, the College should consult with the Comptroller of Maryland and the Office of the Attorney General to identify any tax consequences from this donation. Finally, the College should cooperate with the Attorney General and take any recommended action.

- **Purchase orders were frequently prepared after the invoices had been received. Our test of 15 invoices totaling $800,000 disclosed that purchase orders for 9 invoices totaling $650,000 were not prepared until after the invoice dates. Based on the College's records, we determined that the College processed purchase orders totaling at least $6.4 million during the audit period after the related invoices were received.**

  When applicable, purchase orders should be prepared before the purchases are made and should be used to verify the related invoices prior to payment.

- **The College did not establish adequate procedures to monitor and control funds totaling $11.6 million that were used to pay a food service contractor and funds totaling $1.2 million that were transferred to an overseas fiduciary for the Alba Italy International Program.**

  The College should take the recommended actions to ensure adequate controls are in place over purchases related to the food service contractor and the overseas fiduciary.

- **Adequate controls were not established over the College's collections, which totaled $31.7 million during the period from July 2008 through April 2009.**

  The College should establish procedures to ensure deposits are independently verified to deposit, collections are deposited timely, unique userids are used by employees on the cashier system, and duties are adequately separated.

- **Several deficiencies were noted with respect to the College's automated records. Specifically, student grade changes were not independently verified and were not always approved. In addition, the College did not periodically generate and review system security reports and, as a result, many system users had inappropriate access to critical applications. Finally, the College did not timely reconcile its accounting records with the related State accounting records.**

  The College should establish the recommended controls over student grade changes, periodically generate system security reports to evaluate user access, and timely reconcile its accounting records with the State's records.

- **Sufficient security controls were not in place over significant computer applications, including student administration and financial applications. For example, monitoring of security-related events was inadequate and the College's computer network did not adequately protect against internal and external threats.**

  The College should take the recommended actions to secure its computer applications.

- **Faculty paid leave benefits were not always awarded and monitored in accordance with the College's sabbatical leave policy.**

  The College should enforce and comply with its established sabbatical leave policy.

- **A formal agreement had not been executed between the College and its affiliated foundation, and related payments to the foundation were not always supported.**

  The College should establish a written agreement with its affiliated foundation and ensure all payments made to the foundation are adequately supported and made in accordance with the established agreement.

Background Information

Agency Responsibilities

St. Mary's College of Maryland is a public, liberal arts honors college that offers undergraduate degree programs in various disciplines and a graduate degree in Masters of Arts in Teaching. The College is governed by a Board of Trustees as authorized by the Education Article, Title 14, Subtitle 4. This law provides the Board with broad authority in managing the affairs of the College, and specifies that the Board may not be superseded in its authority by any State agency or office except as expressly provided for in law. Furthermore, the law provides for the College to receive State general funds in the form of an annual grant. According to the College's records, fiscal year 2009 revenues totaled approximately $64.8 million, which included a State general fund appropriation of approximately $16.9 million. Student enrollment for the spring 2009 semester totaled 2,010.

Status of Findings From Preceding Audit Report

Our audit included a review to determine the status of the nine findings contained in our preceding audit report dated March 9, 2007. We determined that the College satisfactorily addressed three of the aforementioned nine findings. The remaining six findings are repeated in this report.

Findings and Recommendations

Purchases and Disbursements

Finding 1
The College acquired undeveloped land adjacent to its campus from an individual affiliated with the College based on an appraisal supplied by the seller, which was significantly greater in value than the College's own independent appraisals. Certain aspects of the sale were not disclosed to the Board of Public Works.

Analysis
The College valued a real estate donation based on the seller's appraisal that specifically prohibited the use of the appraisal by third parties. Specifically, on February 22, 2008, the College's Board of Trustees approved the acquisition of 34.48 acres of land adjoining the campus, which was accomplished by payment of $800,000 and the acceptance of a nonmonetary charitable donation of $825,300 from an individual affiliated with the College. The total value of the land acquired by the College in this manner ($1,625,300) was based on a September 28, 2007 appraisal of the land that was obtained by the seller, which significantly exceeded two other subsequent appraisals obtained by the College. In a letter to the seller dated May 5, 2008, the College stated that, "We are in possession of your appraisal of $1,625,300 for the…property. The College agreed to a bargain sale price of $800,000, with the remaining $825,300 to be accepted as your gift."

This appraisal stated that the value of the land was determined using assumptions developed by the seller; the related report contained numerous disclaimers, including statements that the report should not be used by anyone other than the seller, and that the conclusions and valuation of the property would be different if actual future conditions (such as development plans) were to be different from those assumptions provided by the seller. For example, this appraisal was based on the assumption that the land would be developed into nine residential subdivisions even though the deed limited development to six residential subdivisions. The College was aware of this because the differences in the assumptions were specifically noted in one of the appraisal reports that the College independently obtained. As a result, there could be adverse consequences for the parties involved, including the State of Maryland. For example, tax revenue would be lost if the seller claims the $825,300 amount as a charitable donation in subsequent tax returns.

On April 30, 2008, the Board of Public Works (BPW) approved the purchase of the land for $800,000. The BPW's agenda item submitted by the College listed the purchase price as $800,000 but did not disclose the charitable donation valued at $825,300 the College accepted from the seller as part of the land acquisition. Furthermore, the College did not disclose nor present the seller's appraisal to the BPW. When questioned by the BPW about the $800,000 purchase price, the College presented two other appraisals obtained by the College, dated February 29, 2008 and October 4, 2007, which valued the land at $860,000 and $1.1 million, respectively.[1] The College further stated to the BPW that these appraisals were the current appraisals that it used to determine the purchase price. On May 6, 2008, a deed for the property in the amount of $800,000 was conveyed to the College. Subsequently, the College also added the property to the College's land records with an acquisition price (including settlement fees) of $804,762.

Because of the seller's affiliation with the College, its management requested advice from the State Ethics Commission prior to the land acquisition. In its written response, the State Ethics Commission advised that, based on the limited information provided to it, the seller should not participate in direct discussions with the College regarding the transfer of property. We were advised by the College that the transfer was handled in accordance with this guidance. The Commission was not requested to address and, according to its written response, did not address the purchase price or the value of the remainder gift. The Commission further stated that, to the extent that these values would be established or approved by College officials or employees, there could be issues if there was improper use of position to benefit the seller.

Based on the aforementioned conditions, we referred this matter to the Criminal Division of the Office of the Attorney General.

Recommendation 1

We recommend that the College

a. **retroactively report the additional appraisal and charitable donation to the Board of Public Works,**
b. **value future land transactions based on independent appraisals with correct and current land use assumptions,**
c. **consult with the Comptroller of Maryland and the Office of the Attorney General to identify any tax consequences from the aforementioned donation, and**

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[1]Two appraisals were originally received in June 2007. Due to market fluctuations and other considerations, the College obtained updated appraisals in February 2008 and October 2007 from the two appraisers who prepared the June 2007 appraisals.

d. **cooperate with the Office of the Attorney General and take any recommended action.**

Finding 2
Certain purchase orders were not prepared until the related invoices had been received.

Analysis
For certain purchases, the College prepared the purchase orders after the related invoices had been received. Specifically, our test of 15 invoices, which totaled approximately $800,000, disclosed that, for 9 invoices totaling $650,000, the required purchase orders were not prepared until after the dates on the invoices. The College's procurement policy requires that a written contract and/or purchase order be prepared for purchases of $5,000 or greater. (The value of each of the 15 purchases was greater than $5,000.) We were advised by College management that the purchase orders were prepared after the procurements were made in order to process the related payments. The failure to execute a purchase order or written contract delineating the terms of the purchase in advance, could lead to vendor changes of critical information—including agreed-upon prices and quantities—without the College's approval. Furthermore, this practice bypasses standard procurement processes designed to ensure that proper authorizations are obtained and appropriate procurement methods are used. Finally, appropriate personnel who are responsible for maintaining financial records would be unaware of these purchases until presented with an invoice.

For example, during fiscal year 2007, the College prepared purchase orders for three paintings totaling $87,300 after the invoices were received. The College employees responsible for inventorying the College's artwork were not aware that the paintings were purchased and, when we attempted to sight the paintings, they could not be located. We were subsequently advised that the paintings had been shipped to a local artist for re-framing; however, the College could not provide any documentation to substantiate this. Approximately two weeks after our initial inquiries, the paintings were returned to the College without being re-framed. On July 21, 2009, the College added the paintings to the art collection inventory.

In addition, the failure to prepare purchase orders prior to the actual purchase of these paintings may have contributed to an overpayment. The College received and paid three separate invoices from the art gallery for the three paintings. A subsequent fourth invoice for $10,800 was paid by the College on April 11, 2007, which appeared to duplicate a payment that was made for the same amount on December 13, 2006. After our inquiry, College management contacted the art gallery for an explanation. On July 21, 2009, the art gallery sent the College revised invoices for two of the paintings, reflecting increased purchase prices by a total of $10,800. The College does not believe an overpayment occurred; however, without an established purchase order, the appropriateness of these transactions cannot be determined.

Invoices processed without a pre-existing purchase order are assigned a specific code in the College's automated accounting system. Using this information, and after excluding certain transactions for which a purchase order would not be required (such as debt service payments), we determined that the College processed purchase orders totaling at least $6.4 million during the period from July 1, 2006 to April 29, 2009 after the related invoices were received.

Recommendation 2
For purchases of $5,000 or more, we recommend that purchase orders be prepared before the actual purchases are made and that the purchase orders be used to verify the related invoices prior to payment.

Finding 3
The College did not adequately monitor its food service contractor.

Analysis
The College did not have a process to ensure the accuracy of invoiced charges for its food service contractor, and did not adequately ensure that the contractor exercised appropriate cost controls**.** Effective August 5, 2005, the College contracted with its current food service contractor on a cost-plus fee basis. The contractor is reimbursed for all direct operating costs and is paid an indirect cost fee and a management fee. During the three-year period ending June 2009, the College paid its food service contractor approximately $11.6 million. Specifically, we noted the following conditions:

- Although the vast majority of the contactor payments were reimbursements for direct operating costs (such as food, beverages, labor, and supplies) incurred by the contractor, the College did not obtain supporting documentation (such as supplier invoices and payroll records) to verify the accuracy of these costs. For example, the invoice for the week ending December 6, 2007 totaled approximately $119,400 and included approximately $67,000 for the reimbursement of food and beverage costs, and approximately $47,000 for labor costs. The contract requires all direct operating costs to be properly supported and allows the College to review and approve such documentation before issuing payment.

- The College did not request or obtain an annual plan from the contractor, as required by the contract. The plan should include operating guidelines for the upcoming fiscal year, such as proposed menus and pricing structures, operating cost budgets, and proposed adjustments to contract compensation. Once approved by the College, the plan should be incorporated into the contract and the contractor would not be able to substantially deviate from it, without the expressed written consent of the College. We did note that there were no significant increases in fees during the audit period.

The nature of cost-plus fee based contracts requires additional oversight and administration to ensure that only permissible costs are paid and that the contractor is exercising adequate overall cost controls.

Recommendation 3
We recommend that the College

a. establish procedures to ensure the propriety of contractor costs through periodic verification with supporting documentation (for example, employee time sheets, contractor expenditure records, and receipts for food purchases) to ensure the amounts reported by the contractor are proper; and

b. obtain the required annual plan, review the plan for appropriateness, and incorporate the plan into the contract after approval.

Finding 4
The College did not monitor and control funds transferred to an overseas fiduciary for the Alba Italy International Program.

Analysis
The College did not establish procedures to monitor and control funds electronically transferred to an overseas fiduciary (that is, an individual) responsible for paying invoices on the College's behalf for the Board-approved Alba Italy International Program**.** The Program is run by college personnel, but financial transactions are handled by the fiduciary. Specifically, at the beginning of each semester and as needed throughout the semester, the College estimated the amount needed for the Program's expenses (such as lodging, meals, supplies) based on the number of students enrolled, and electronically transferred the funds to the fiduciary. Throughout the semester, the fiduciary received the Program invoices (written in Italian and in euros) from the Program Director, translated the invoices, converted the invoiced amounts into U.S. dollars, and paid the invoices. A summary schedule and the original invoices were then submitted to the

College. During our audit period, the College electronically transferred approximately $1.2 million to the fiduciary for reimbursement of Program expenses and for management fees. Our review disclosed the following conditions:

- The College did not have a current contract and surety bond with the fiduciary and was not sure how much it was paying the fiduciary for its management fee. In the past, the College contracted with the fiduciary for one semester period at a time; however, the most recently approved contract was for the Fall 2007 semester. Since that contract expired at the end of the Fall 2007 semester, according to the College's records, it has paid the fiduciary approximately $985,000 for program expenses and management fees as of April 2009. According to the last approved contract, the fiduciary's management fee was 3,000 euros (or approximately $4,400) per semester. The College advised that it believes the current management fee is 8 percent of funds transferred to the fiduciary.

- The College did not obtain a monthly bank reconciliation of the fiduciary's accounts or annual independent audits, both of which were required in past contracts. We were advised by the College that it relied on the fiduciary to notify it when the bank account balance was low and then it would electronically transfer the amount of funds needed.

- The College did not require the fiduciary to maintain a separate bank account for the College program's deposits and disbursements. Rather, the fiduciary comingled the College's funds with other clients, resulting in a lack of accountability. In this regard, the College was unable to independently reconcile funds transferred to the fiduciary with actual Program expenses.

- Documentation for Program expenses submitted by the fiduciary was not always adequate to support the propriety of the expenses. For example, for one receipt for a restaurant bill for 67 people, totaling 670 euros (or approximately $980), the fiduciary did not provide a list of the specific individuals and did not explain how the meals expense related to the Program. We also noted several instances in which an extra charge of four percent was added to the invoiced amount for exchange rate discrepancies and wire transfer fees. For example, one $90,306 invoice included an additional $3,613 to cover a wire transfer fee and exchange rate discrepancies. We were advised by College management that an additional four percent was added to address wire transfer fees and any potential discrepancies in exchange rate conversions; however, there was no subsequent review and settlement of these additional payments.

Recommendation 4
We recommend the College

a. **immediately execute a contract with the fiduciary defining the responsibilities and fees associated with the Program, including the fiduciary's management fee, and requiring that the fiduciary secure a surety bond;**
b. **obtain a monthly bank reconciliation of the fiduciary's accounts related to the College's activities, as well as an annual independent audit, and review and reconcile the fiduciary's records of Program expenses with the College's records;**
c. **ensure that the fiduciary maintains a separate bank account for the College's activity; and**
d. **obtain sufficient documentation from the fiduciary to determine the appropriateness of Program expenses and only pay for expenses directly related to the Program.**

Cash Receipts

Finding 5
Controls over the College's collections were inadequate.

Analysis
Controls over the College's collections, which according to its records, totaled approximately $31.7 million during the period from July 1, 2008 through April 16, 2009, were inadequate. Specifically, our review disclosed the following conditions:

- Independent verifications were not performed to ensure that all recorded collections were deposited. Specifically, the employee responsible for performing the deposit verification was not independent of the cash receipt collection process.

- Collections were not always deposited in a timely manner. Specifically, our test of 15 deposits, totaling $620,900, disclosed that 6 deposits, totaling $249,000, were forwarded to the bank for deposit from three to five business days after receipt. A similar condition was commented upon in our preceding audit report.

- Two cashiers and their supervisor shared a logonid and password that was used to process collections in the College's cashier system; consequently, there is a loss of accountability over the related transactions.

- Two employees who maintained the student accounts receivable records also had access to the related collections. Accordingly, the accounts receivable records could be altered to conceal a misappropriation.

Recommendation 5
We recommend that

a. an employee independent of the cash receipts process perform the deposit verifications,
b. collections be deposited in a timely manner (repeat),
c. unique logonids be used by each employee responsible for recording cash receipts in the cashier system, and
d. employees who maintain accounts receivable records not have access to the related collections.

We advised the College on accomplishing the necessary separation of duties using existing personnel.

Verification of Student Grades

Finding 6
The College had not established adequate controls over changes to student grades recorded in the automated system.

Analysis
The College did not generate output reports of student grade changes to facilitate an independent verification of recorded changes to applicable source documents. As a result, unauthorized modifications could be made to student grades without detection. The lack of a documented review of student grade changes was commented upon in our preceding audit report. According to the College's records, 406 grade changes were processed during the period from December 20, 2007 to June 17, 2009.

In addition, our tests disclosed that grade changes were not always processed in accordance with College policy. The College's policy requires the grade changes to be based on grade change forms initiated by a faculty member and approved by the applicable department chair. However, our test of 12 grade changes disclosed that 10 grade changes were not processed consistent with this policy. For example, two grade changes were not supported with a grade change form and seven were not properly approved by the appropriate department chair.

Recommendation 6
We recommend that

a. **changes to grades be processed and approved in accordance with the College's policy,**
b. **output reports of student grade changes be generated, and**
c. **changes be verified to the related source documents by employees independent of the grade change functions, and that these verifications be documented and retained for future reference (repeat).**

Automated System

Finding 7
The College did not ensure that user access to certain critical applications on its automated system was proper.

Analysis
The College did not periodically generate and review system security reports of user access capabilities assigned to certain critical applications on its automated system. Consequently, the College lacked assurance that user capabilities were assigned in a manner that only granted employees those capabilities needed to perform their assigned duties. Our review of all 52 active system users assigned to critical applications disclosed that a number of system users did not need certain assigned accesses to perform their duties.

Access to Critical Applications

Critical Application	Number of Assigned Users[1]	Exception Conditions Number of Assigned Users: Unnecessary Access	Exception Conditions Number of Assigned Users: Former Employees[2]
Modify Purchase/Disbursement Transactions	43	36	0
Change Student Residency Status	17	15	1
Change Student Grades	16	11	1
Modify Student Accounts (issue noncash credits)	17	11	1
Modify Tuition and Fee Tables	9	7	2
Totals	**102**	**80**	**5**

[1]Individual system users are assigned access to multiple critical applications
[2]Included in count of unnecessary access

According to industry best practices, as described by the Department of Information Technology's (DoIT) *State Information Technology Access Control Standard*, a documented review of system access should be conducted at least annually.

Recommendation 7

We recommend that the College

a. periodically generate computer system security reports and use these reports to evaluate assigned user access privileges, and

b. grant specific user access privileges only to those employees who require such privileges to perform their assigned job duties and immediately remove the aforementioned inappropriate access privileges.

Finding 8

The College did not reconcile its accounting records with the related records of the State Comptroller in a timely manner.

Analysis

The College did not reconcile its automated accounting records with the related records of the Comptroller of Maryland in a timely manner. The College performed separate reconciliations for revenues and expenditures; however, our review disclosed that, as of April 2009, the most recent reconciliation of revenues was for the month of January 2009, and the most recent reconciliation of expenditures was for the month of June 2008. As of June 30, 2009, reconciliations had not been performed beyond the aforementioned dates and we noted differences between the College and related State records totaling approximately $4.6 million for revenues and approximately $905,000 for expenditures, which will need to be investigated and resolved.

The College processes transactions on its automated accounting system, which are interfaced daily with the State's accounting system. Timely reconciliations are needed to ensure that all transactions are posted correctly. A similar condition was commented upon in our preceding audit report.

Recommendation 8

We recommend that the College periodically reconcile its financial records with the records of the Comptroller of Maryland and investigate any reconciling differences in a timely manner (repeat).

Information Systems Security and Control

Background
The College's information technology environment includes an integrated administrative and academic computer network that provides connections to a substantial number of servers and workstations. Key network resources include an administrative minicomputer, which processes financial applications, including campus financial data and student accounts receivable, and other significant applications including student academic records. Other key network resources include separate email and file servers, Internet connectivity, firewalls, and core network switches used to protect segments of the network, as well as multiple campus websites that function as entry points into many of the College's services.

Finding 9
Logging and monitoring of significant security-related events were not adequate.

Analysis
Logging and monitoring of significant security-related events for a critical database and its host server were not adequate. Specifically, the database and host server auditing features were disabled. As a result, virtually no security-related database and server events were logged or monitored. These same conditions were commented upon in our preceding audit report.

The database contains critical production data, such as student records, grades, financial aid, accounts receivable, and accounts payable. Examples of database and server activities that should be logged and analyzed include direct changes to critical data tables, changes to database table security settings, and changes to user accounts and file permissions. The Department of Information Technology (DoIT) *Information Security Policy*, which represents industry best practices, states that security logging and monitoring should be performed to ensure accountability of system and security-related events.

Recommendation 9
We recommend that, for its critical database and host server, the College implement industry best practices for logging and monitoring as described in the aforementioned DoIT *Information Security Policy* (repeat).

Finding 10
The internal network was not properly protected from security risks.

Analysis
The internal network was not properly protected from security risks. Specifically, we noted the following conditions:

- IDP (intrusion detection prevention) systems were not properly utilized to protect critical portions of the internal network. While the network included an IDP system, its placement did not protect critical systems from threats originating from untrusted internal network connections (for example, student residence halls). In addition, the IDP system was not configured to automatically send email alerts for critical or emergency conditions and had not been adequately updated for the latest threat signatures (that is, known malicious patterns in executable software). IDP systems gather and analyze network traffic to identify and block network security breaches and attacks, and alert network administrators of these situations. DoIT's *Information Security Policy,* which represents industry best practices, states that networks should be continually monitored by intrusion detection/prevention systems at critical junctures.

- Several widely accessible servers and websites were located on the College's internal network rather than being placed in a neutral network zone. Publicly/widely accessible servers and websites should be placed in a neutral network zone, separate from the internal network, to enhance protection of sensitive data and systems on the internal network. A similar condition was noted in our preceding audit report.

- Key administrative systems were not adequately protected from untrusted internal network devices. Specifically, workstations in the student computer labs could access computers running critical administrative systems. Protecting critical administrative portions of the College's network from untrusted parties by use of proven security measures (such as a properly configured firewall) is essential in ensuring the integrity of the administrative systems and applications. A similar condition was noted in our preceding audit report.

Recommendation 10
We recommend that the College properly secure its internal network from both internal and external exposures (repeat). We made detailed recommendations to the College, which if implemented, should provide for adequate security over its network.

Finding 11
Critical application user credentials were exposed to possible disclosure and misuse.

Analysis
Critical application user credentials were exposed to possible disclosure and misuse. The College used the same userids and passwords to authenticate users to both critical and non-critical applications. Although critical applications encrypted the userids and passwords submitted to the application for authentication, a few non-critical applications transmitted the same userids and passwords in clear text for authentication. Therefore, userids and passwords transmitted in clear text could be intercepted, read, and then used to access the critical applications (such as the system used to post and maintain student grades) with the privileges assigned to the legitimate application user.

Recommendation 11
We recommend that the College use secure (encrypted) protocols for transmission of all userids and passwords to both critical and non-critical applications.

Finding 12
Weaknesses were found in the administration of critical network devices exposing the internal network to security risks.

Analysis
Security control weaknesses existed in the procedures used to administer critical network devices, exposing the College's internal network to security risks. Specifically, we noted the following conditions:

- Connections to remotely administer the Internet firewall and a core network switch were permitted from numerous network devices rather than being permitted from only specific workstations or network segments used only by the network support staff. A similar condition was commented upon in our preceding audit report.

- The Internet firewall was not configured to send email alerts to firewall administrators for firewall problems and possible attacks. In addition, log files stored on the firewall were overwritten when filled, resulting in lost logging information. Finally, we were advised that regular reviews of the firewall logs were not performed.

- College personnel advised us that they used a secure connection protocol to administer a core network switch. However, an insecure connection protocol was enabled on this device, which if used, transmitted information, including userids and passwords, in clear text across the network. A similar condition was noted in our preceding audit report.

Recommendation 12
We recommend that the College

a. restrict remote administrative connections to these critical network devices to only authorized firewall administrators (repeat);
b. configure the Internet firewall to send email alerts to the firewall administrators;
c. store the firewall logs on a separate secure server;
d. regularly review the firewall logs, document all reviews performed and retain the documentation for verification purposes; and
e. **disable all insecure connection protocols for remote administrative connections to the core network switches (repeat).**

Finding 13
The College's information systems disaster recovery plan and backup procedures were not adequate.

Analysis
The College's information systems disaster recovery plan and backup procedures were not adequate. Specifically, we noted the following conditions:

- The College did not have a complete information technology disaster recovery plan for recovering from disaster scenarios (such as a fire). Specifically, the College's plan did not adequately address certain critical elements as stated in the Department of Budget and Management's (DBM) *Information Technology Disaster Recovery Guidelines*. Specifically, the plan did not address the use of alternate sites and network restoration procedures, and had not been tested. DoIT's *Information Security Policy*, which represents industry best practices, states that entities should develop, implement, and test an information technology disaster recovery plan for each critical system to ensure that contingency procedures will be available in the event of a disaster resulting in the loss of services from the primary production system.

- Backup copies of certain critical network devices' configurations were stored on an employee's workstation rather than at a secure off-site facility. According to the DBM *Disaster Recovery Guidelines*, backup media should be stored off-site in a secure, environmentally controlled location.

Recommendation 13
We recommend that the College
a. develop and periodically test a complete disaster recovery plan in accordance with the DBM *Information Technology Disaster Recovery Guidelines;* and
b. store backup copies of its critical network devices' configurations at an off-site, secure, and environmentally controlled location.

Employee Benefits

Finding 14
The College did not always award and monitor sabbatical leave in accordance with its leave policy.

Analysis
Leave was not always awarded and monitored in accordance with the College's paid faculty development leave program (sabbatical) policy. Specifically, our test of sabbatical leave awarded to 13 employees disclosed the following for 3 employees:

- For two employees, either a proposal was not submitted for sabbatical leave or the proposal was not in accordance with the College's policy.

- One employee did not return to work after being on sabbatical leave and the sabbatical leave contract approved by the Board of Trustees did not grant a waiver to exempt the employee from returning to work (and forfeiting the sabbatical leave payment). This employee was awarded a salary of $45,778 while on sabbatical leave. The College did not pursue recovery of the sabbatical leave payment.

- Two employees did not submit the required final reports to the College detailing their activities and accomplishments during their sabbatical leave. Based on our inquiries, the College requested and received the reports from these employees in July 2009. However, one employee should have submitted the final report in August 2007 and the other in August 2008.

According to the College's policy, pre-tenured faculty and tenured faculty are eligible for sabbatical leave for a semester or a full year. Faculty must submit a proposal to the College for review and approval that details the work to be performed, the expected results, any external funding available, and the significance to the employee's professional development. Furthermore, faculty must submit a final report by August 15th in the year following their sabbatical leave to the College's Provost detailing the activities and results of their sabbatical leave. Finally, tenured faculty granted sabbatical leave are required to serve on the staff of the College for at least one year after the expiration of their leave unless a waiver is expressly granted by the Board of Trustees.

Recommendation 14

We recommend that the College strictly comply with its established sabbatical leave policy. Specifically, we recommend that the College

a. ensure that employees submit the required proposals for review and approval before sabbatical leave is awarded,

b. pursue recovery of the sabbatical leave award from the aforementioned employee that did not return to work and was not granted a Board waiver, and

c. ensure employees submit the required final reports detailing the activities and accomplishments during the sabbatical leave.

Affiliated Foundation

Finding 15

A formal agreement had not been executed between the College and its affiliated foundation. In addition, payments to the foundation were not always supported.

Analysis

A written operating agreement had not been executed between the College and its affiliated foundation. The foundation was established in 1972 primarily to provide support for the faculty and students of the College by raising and investing funds. Certain college employees perform work for the foundation, and the College provides administrative office space and use of facilities to the foundation. In this regard, we noted that payments to the foundation, which totaled $676,130 during the period November 2006 to June 2009, were not always supported. Specifically, our test of 15 of these payments totaling $515,600 disclosed that 8 payments for reimbursement of College-related expenses totaling

$81,600 were not supported. These unsupported payments related to travel expenses incurred by College employees, printing and postage expenses, and expenses for the College's Board of Trustees.

Without a written operating agreement, the parties' roles and responsibilities may not be clear. This agreement should include, but should not be limited to the following provisions: (a) a definition of the relationship between the two entities and the purpose of the foundation, (b) specifics as to what support the College will provide to the foundation (office space, support staff) and how these costs will be reimbursed to the College, and (c) a statement that the foundation may not make political contributions or participate in any political campaign for or against any candidate for public office.

We were advised that the College is currently in the process of negotiating an agreement with the foundation. However, as of July 2009, a final signed agreement had not been approved.

Recommendation 15

We recommend that the College

a. establish a written agreement with its affiliated foundation which contains all critical provisions, and

b. ensure all payments made to the foundation are supported and in accordance with the established agreement.

Audit Scope, Objectives, and Methodology

We have audited the St. Mary's College of Maryland for the period beginning July 1, 2006 and ending April 12, 2009. The audit was conducted 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.

As prescribed by State Government Article, Section 2-1221 of the Annotated Code of Maryland, the objectives of this audit were to examine the College's financial transactions, records and internal controls, and to evaluate its compliance with applicable State laws, rules, and regulations. The areas addressed by the audit included procurements and disbursements, information systems, student accounts receivable, cash receipts, and payroll. We also determined the status of the findings included in our preceding audit report.

In planning and conducting our audit, we focused on the major financial-related areas of operations based on assessments of materiality and risk. Our audit procedures included inquiries of appropriate personnel, inspection of documents and records, and observations of the College's operations. We also tested transactions and performed other auditing procedures that we considered necessary to achieve our objectives. Data provided in this report for background or informational purposes were deemed reasonable, but were not independently verified.

The College provides certain support services (such as purchasing, data processing, and maintenance of accounting records) to the Historic St. Mary's City Commission. These support services are included within the scope of our audits of the College. In addition, our audit did not include an evaluation of internal controls for federal financial assistance programs and an assessment of the College's compliance with federal laws and regulations pertaining to those programs because the State of Maryland engages an independent accounting firm to annually audit such programs administered by State agencies, including the College.

The College's management is responsible for establishing and maintaining effective internal control. Internal control is a process designed to provide reasonable assurance that objectives pertaining to the reliability of financial records, effectiveness and efficiency of operations including safeguarding of assets, and compliance with applicable laws, rules, and regulations are achieved.

Because of inherent limitations in internal control, errors or fraud may nevertheless occur and not be detected. Also, projections of any evaluation of internal control to future periods are subject to the risk that conditions may change or compliance with policies and procedures may deteriorate.

Our reports are designed to assist the Maryland General Assembly in exercising its legislative oversight function and to provide constructive recommendations for improving State operations. As a result, our reports generally do not address activities we reviewed that are functioning properly.

This report includes findings relating to conditions that we consider to be significant deficiencies in the design or operation of internal control that could adversely affect the College's ability to maintain reliable financial records, operate effectively and efficiently, and/or comply with applicable laws, rules, and regulations. Our report also includes findings regarding significant instances of noncompliance with applicable laws, rules, or regulations. Other less significant findings were communicated to the College that did not warrant inclusion in this report.

The College's response to our findings and recommendations is included as an appendix to this report. As prescribed in the State Government Article, Section 2-1224 of the Annotated Code of Maryland, we will advise the College regarding the results of our review of its response.

APPENDIX

St. Mary's College of Maryland
at Historic St. Mary's City

Office of the President

February 11, 2010

Via telecopier and first-class mail
Mr. Bruce A. Myers
Legislative Auditor
Department of Legislative Service
Office of Legislative Audits
Maryland General Assembly
301 West Preston Street, Room 1202
Baltimore, Maryland 21201

Dear Mr. Myers:

Please find attached the response to the draft audit report on St. Mary's College of Maryland for the period beginning July 1, 2006 and ending April 12, 2009. Thank you for providing the requested brief extension to the response period.

Sincerely,

Larry E. Vote
Acting President

cc: Mr. James Muldoon, Chair
Board of Trustees

Mr. John Wobensmith, Chair
Finance, Investment and Audit Committee, Board of Trustees

18952 E. Fisher Road, St. Mary's City, Maryland 20686
240-895-4410/800-458-3145 · www.smcm.edu · fax 240-895-4962

St. Mary's College of Maryland
Response to Legislative Audit Findings: July 1, 2006 to April 12, 2009
February 12, 2010

Overview

St. Mary's College of Maryland (hereafter "the College") provides the following responses to the Legislative Audit Findings from July 1, 2006 to April 12, 2009. Throughout this extensive audit process which spanned months, the College has made every effort to respond promptly, thoroughly and completely to every request by the legislative auditors. The College takes these findings very seriously and, with the exception of Finding 1, has concurred with the auditors' recommendations and has provided specific timelines and methods to be used by the College to address the issues raised by the auditors in these findings.

With respect to Finding No. 1, however, the College strenuously objects to this finding and considers the conclusion reached by Finding 1 to be without merit. In an effort to fully assess the facts underlying this matter, the Board of Trustees of the College had an independent investigation conducted and a full report is included as an attachment to these responses and is incorporated by reference. In summary, the investigation findings concluded that "the College's representatives acted lawfully and in the College's best interest throughout the process of negotiating the purchase and obtaining a BPW approval." The College's gift acknowledgment letter, as the investigation found, "was the result of a good-faith attempt to adapt the Development Office's protocol for accepting property donations to the extraordinary circumstance of a bargain purchase." Accordingly, the College objects to this finding in its entirety.

Responses to Legislative Audit Findings:

Finding 1: The College acquired undeveloped land adjacent to its campus from an individual affiliated with the College based on an appraisal supplied by the seller, which was significantly greater in value than the College's own independent appraisals. Certain aspects of the sale were not disclosed to the Board of Public Works.

Response: The College strongly objects to Finding 1 as it contains factual errors and misinterprets significant elements of the real estate transaction in question. It is important to note that the transaction was handled in an arm's length deal by the Attorney General's Office and the seller's attorney. The Maryland State Ethics Commission was contacted two times (before and after the transaction) to ensure that since the land at issue was sold under fair market value to the College by a Trustee of the College that there was no conflict of interest in the transaction.

Clearly, the College did not acquire the property based on an appraisal supplied by the seller as asserted in this finding. The acquisition was based on two independent appraisals obtained by the OAG and the asset was booked at a price below the appraised value. The College's acknowledgment of the seller's appraisal was not for valuation purposes and had no bearing on the transaction. The College in no way intended to warrant or validate the seller's appraisal. In accordance with the Internal Revenue Code, the establishment of the Fair Market Value for tax purposes is solely the responsibility of the donor (seller).

The College followed the practice of the St. Mary's College of Maryland Foundation in using the seller's appraisal in creation of the gift letter. The College agrees that it would be better to include no reference to the seller's appraisal in the gift amount but, in doing so, it has committed no wrongdoing and strenuously objects to the note referring this matter to the Criminal Division of the Attorney General's Office. The College has repeatedly offered to correct the letter to simply acknowledge the bargain sale gift, and again requests that this finding be deleted in its entirety.

Given the seriousness of the assertions made in the finding, the Board of Trustees of St. Mary's College of Maryland directed the Chair of the Finance, Investment and Audit Committee to initiate an independent investigation of the underlying facts and circumstances concerning the real estate transaction that is the subject matter of this finding. To this end, the College retained on a *pro bono* basis, the services of Richard E. Timbie, an attorney at Caplin & Drysdale in Washington, D.C. Mr. Timbie was retained for the limited purpose of investigating this matter to advise the Board of Trustees whether the negotiation, approval, or acknowledgement of the bargain purchase involved any illegal conduct or other impropriety on the part of the College or its representatives. In his seven-page report which has been included and incorporated to the College's response by reference, Mr. Timbie concluded as follows:

"In my opinion, the College's representatives acted lawfully and in the College's best interest throughout the process of negotiating the purchase and obtaining a BPW approval. The inappropriate language in the College's acknowledgement letter did not reflect any intentional wrongdoing, much less any criminal violation, on the part of the College or its agents. That language was not intended to create, and could not have created, an unwarranted tax benefit for the seller. Rather, it was the result of a good-faith attempt to adapt the Development Office's protocol for accepting property donations to the extraordinary circumstance of a bargain purchase."

Notwithstanding the fact that the College strenuously objects to this finding, it will send a letter to the Board of Public Works to retroactively acknowledge receipt of the seller's appraisal, noting that all three appraisals are in excess of the amount paid for the property. As always, the College will cooperate with the Office of the Attorney General and take recommended actions, noting that this transaction was negotiated at arm's length through the Office of the Attorney General.[1]

Finding 2: College purchase orders were not prepared until the related invoices had been received.

Response: The College concurs with this recommendation. It agrees that best practice is to initiate a purchase order prior to the performance of work. In accordance with the College's procurement

[1] **<u>Auditor's Comment</u>**: In its response, the College stated that it objects to Finding 1 because the finding contains errors of fact and misinterprets significant elements of the subject real estate transaction. The structure of this transaction, as presented in the finding, is based on the College's May 5, 2008 letter acknowledging the donor's gift, and the minutes of the Board of Trustee's executive session held on February 22, 2008, in which the transaction was approved. Accordingly, we continue to believe that the finding, as presented in this report, is accurate and valid. Minor wording changes, however, were made to this finding based on the College's response.

policy, any purchases greater than $5,000 are to be done through the Purchasing Office. The policy details required approvals which in all cases were obtained. In light of this finding the College Procurement Office will develop training materials to address specific concerns and conduct training sessions with all parties involved in procurements no later than summer 2010.

Finding 3: The College did not adequately monitor its food service contractor.

Response: The College agrees with the recommendation with this explanation. The food service vendor supplies the College with weekly reports supporting the costs invoiced for the period. While the contract language requires the contractor to make more detailed records available, it does not require the College to request and review them. Notwithstanding, the College agrees to periodically request such records for review for a randomly chosen week each year. The first such review will occur before May 2010. In the matter of item b. the College agrees that the contract files should contain evidence of a review of the annual plan.

Finding 4: The College did not monitor and control funds transferred to an overseas fiduciary for the Alba Italy International Program.

Response: The College concurs with this recommendation and will work to improve the control mechanisms in place for the Alba program. Given the constraints of distance and the rapidly evolving program, the College did its best to monitor and control funds. The turnover in the College's comptroller's position and similar turnover in the purchasing position, both of which had three different incumbents during the period involved, challenged the College's ability to properly handle the transactions through the fiduciary. The contract with the fiduciary will be renewed by March 2010; the current management fee is 8%.

The College transfers money to the fiduciary in advance of the fiduciary making any payments. The funds are credited to the College, and then the bills are paid against that total. Furthermore, except for capital improvements, the "invoices" are always estimates of future expenses based on known items, such as rent payments, and other specifically unknown items, such as meals. Miscellaneous expenses are based on a budget prepared at the beginning of the semester as well as more current estimates by management after the budget was prepared. The bills in Italy are paid in Euros, while the State makes payments in dollars.

Prior to January 2010, we entered the payment information in dollars in FMIS and instructed the General Accounting Division to buy the equivalent amount of Euros. The actual exchange rate was unknown at that time, so we estimated the dollars needed based on the current quoted wholesale rate. Based on past practices, we understand that the State does not get the wholesale rate and that the exchange rate changes every day, hour, or minute between calculating and paying. Accordingly, the College added a percentage which in our experience would make the amount of Euros purchased at least equal to the amount needed. In the case of the Alba program, any surplus remained as College funds and was used to pay College bills. In the case of the Oxford program, the College typically received a refund of any overpayment. In January 2010, the College developed a new procedure with GAD to allow the transfer of an exact quantity of foreign currency, thus eliminating the need to use estimates. We are now using this new procedure.

Specific responses to recommendations: The College agrees to execute a contract with the Fiduciary in March 2010. The College will explore the issue of executing a performance bond and will do so if the arrangement continues and this option is economical. Moreover, the College is currently working to set up an Italian bank account which would eliminate the need for the fiduciary. Such an arrangement would also eliminate the need for recommendations b. and c. of the audit report.

Finding 5: Controls over the College's collections were inadequate.

Response: Overall, St. Mary's College of Maryland agrees with the conclusion of Finding 5, but offers the following explanation. At the current time, both accounts receivable employees receipt cash at different times (only one on any given day) and only one employee performs the verification. The employee doing the verification is the more senior employee who is more highly skilled and paid significantly more than the junior staff member. It is not possible or practical to split this duty between the employees given their differing experience levels. The accounts receivable supervisor counts out the cash drawer each day for the employee who served as cashier and then reviews and signs off on the deposit verification each day. The College will make every effort to ensure that the verification is performed in the most independent method possible under these circumstances.

While we do not dispute that more frequent bank deposits would be more desirable, this is not possible at the present time due to limited staffing in the public safety department. The current three day a week bank deposit run is the maximum amount of bank runs our current public safety staff can maintain in addition to their other campus duties. We will continue to analyze deposit activity and identify peak periods, such as the beginning of each semester, where the daily volume is greater than $100 thousand. Daily deposit runs will continue to be made during these peak periods. It is noteworthy that within the past year, the College has implemented online payments through Cashnet where students and parents can pay their bills electronically using either a free automated clearinghouse account or MasterCard with a convenience fee. This service was heavily utilized for the fall 2009 semester which cut down on the payments receipted and taken to the bank by the accounts receivable office. Electronic payments were greater than $3.5 million and are expected to increase in future semesters. As a result of these online banking options, the College foresees a dramatic decrease in the amount of cash intake.

In response to the note that access to the cashier system was not properly segregated, the College agrees to establish segregated (unique) passwords. The College can feasibly do this segregation and will implement it by July 2010. With respect to recommendation d. to ensure employees with access to cash receipts do not have access to the related collections, it is not possible with the current staff count in the department to implement this level of segregation. The College will, however, explore alternate controls to specifically address these concerns.

Finding 6: The College had not established adequate controls over changes to student grades recorded in the automated system.

Response: The College concurs with these recommendations. Proper reports have been identified that will allow for audits of changed grades after the grading deadline and the College will run them periodically. The Registrar, who is outside of the process of entering the grades, will verify grade changes in accordance with policy and retain source documents for future verification.

Finding 7: The College did not ensure that user access to certain critical applications on its automated system was proper.

Response: The College agrees to comply with this recommendation. The College will periodically review assigned user access privileges and grant access privileges only to those employees who require such privileges. The College agrees that there needs to be a yearly review of user access and privileges to ensure that user access to certain critical Jenzabar applications is proper. The review will consist of reports to be reviewed, documented, and signed off. The review will be implemented by June 2010.

Finding 8: The College did not reconcile its accounting records with the related records of the State Comptroller in a timely manner.

Response: The College concurs with this recommendation and the business office will work to improve the timeliness of its reconciliation of accounting records. By way of explanation, turnover in the accounting department during this time period has been significant. The College had three different Comptrollers in a three-year period, and the revenue accountant position was vacant at the time the audit began after the incumbent was promoted to accounts receivable supervisor. Since that time, the revenue accountant position has been filled and the department has stabilized. Timely reconciliations are important goals for the department moving forward.

Finding 9: Logging and monitoring of significant security-related events were not adequate.

Response: The College concurs with the recommendation and will implement the database audit process by July, 2010. Critical financial data elements will be determined and at that time will be audited. An on-going review process will also be put in place. Enabling system events will also be reviewed at this time. The College will enable the important system security events and run scripts to monitor failed logins.

Finding 10: The internal network was not properly protected from security risks.

Response: The College concurs with the recommendations and will review its network design to limit "untrusted" segments. Our goal is to have internal IDP systems in place by fall 2010. A process to store and review IDP logs will also be created by fall 2010. All new public servers have been placed in the DMZ and we have been moving existing servers as we are able. The outdated ACL entries were removed Oct 26, 2009. We will develop and implement ACL's on the computer lab vlans by fall 2010.

Finding 11: Critical application user credentials were exposed to possible disclosure and misuse.

Response: The College concurs with the recommendation and will develop processes to have all unsecure access removed by fall 2010.

Finding 12: Weaknesses were found in the administration of critical network devices exposing the internal network to security risks.

Response: The College concurs with the recommendation and has renamed administrative account and restricted access to required IP addresses. The Internet Firewall has been configured to send alerts to administrators and we will develop a process to store and analyze the log files on a separate server by fall 2011. Unsecure protocols have been disabled on the core switch.

Finding 13: The College's information systems disaster recovery plan and backup procedures were not adequate.

Response: The College concurs to further improve its Disaster Recovery Plan (DRP). Lists of replacement equipment are now included in the DRP which has been placed on a CD and stored at the off-site storage location. Physical and logical network diagrams for restoring the network if the primary server room is damaged or destroyed will also be incorporated into the plan. The College will further assess its DRP to determine what additional information should be added. The College will also conduct and document "table-top testing" by performing a walk-through of disaster recovery procedures with members of the DR team at least once per year.

The College will develop and implement a procedure for backing up and storing configurations for critical networks by fall 2011.

Finding 14: The College did not always award and monitor leave in accordance with its Paid Faculty Development Leave Program policy.

Response: The College has consistently followed its process for proposal and review before a sabbatical leave is awarded. We agree that our filing of such requests was not sufficient and will take steps to document all sabbatical leaves in the future, as well as documenting final reports from sabbatical leaves. We also agree to report to the Board of Trustees when an employee is granted a waiver from returning to work following a sabbatical, and will do so for the previously granted exemption that was approved by the provost. The sabbatical leave program serves the College well through extensive faculty development activities and we are pleased to take the additional steps in support of this outcome.

Finding 15: A formal agreement had not been executed between the College and its affiliated foundation. In addition, payments to the Foundation were not always adequately supported.

Response: The College concurs with the recommendation and has provided the auditors with a copy of the draft agreement between the College and the Foundation. The proposed agreement includes the points suggested in the auditor comments. The draft has been sent to the Foundation Board for review and approval. It will then be presented to the College's Board of Trustees for approval. The College and Foundation anticipate completing this process in February 2010. With respect to the finding that payments to the Foundation were not adequately supported, the College agrees to carefully monitor and improve controls on its process with respect to all payments to the Foundation.

Caplin & Drysdale
ATTORNEYS

Caplin & Drysdale Chartered
On e Thomas Circle, NW
Washington DC, 2005-5802

TO: John C. Wobensmith
Chair, Finance, Investment & Audit Committee
St. Mary's College Board of Trustees

FROM: Richard E. Timbie
Caplin & Drysdale

DATE: February 10, 2010

RE: Bargain Purchase of Real Estate

On May 6, 2008, St. Mary's College of Maryland (the "College") purchased two parcels of land adjacent to its campus from a member of the College's Board of Trustees (the "Seller"). The draft report of a recently completed audit of the College by the Maryland Department of Legislative Affairs includes a finding that the purchase "was based on an appraisal supplied by the seller, which was significantly greater that the College's own appraisals," and that "[c]ertain aspects of the sale were not disclosed to the Board of Public Works" when it approved the purchase. The draft report also alleges that, because the College valued the property donation attributable to the bargain purchase price based on an appraisal provided by the Seller, it may have created a charitable deduction for the Seller that would result in a loss of tax revenue for the State of Maryland. The legislative auditor has referred the matter to the Criminal Division of the Maryland Attorney General's Office.

You have asked me to review the facts and documentation relating to the transaction and advise the Board of Trustees whether the negotiation, approval, or acknowledgment of the bargain purchase involved any illegal conduct or other impropriety on the part of the College or its representatives.

Facts

1. The Seller became a member of the College's Board of Trustees in September 2005. At that time he owned two contiguous parcels of land adjacent to the north end of the campus that totaled approximately 34.5 acres (the "Real Estate"). He had purchased the Real Estate in 2004 with the intention of developing it as residential housing.

2. The proposed residential development would have been inconsistent with the College's setting and landscape protection strategy for its campus located within the Maryland State historical site, St. Mary's City. Shortly after the Seller joined the Board of Trustees, the College requested that he not proceed with his development plans. He and the College later began discussing the possibility that the College might acquire the Real Estate for a below-market price.

3. Both parties recognized that the Seller's status as a trustee raised a potential for a conflict of interest. In December 2006 Thomas Botzman, the College's Vice President for Business and Finance, sought advice from the State Ethics Commission. In a letter dated January 4, 2007, the Commission advised Mr. Botzman that negotiation of the acquisition could proceed but that (a) the Seller should not participate as a trustee in the College's consideration of the transaction, and (b) the Seller should be represented by an attorney or other agent in all direct discussions with the College.

4. Negotiations for the College's acquisition of the Real Estate were conducted between the Seller's attorney and Alexander Short, an Assistant Attorney General in the Educational Affairs Division of the Maryland Attorney General's Office. Mr. Short was selected to act as the College's agent because he has expertise in real estate law. Sara Slaff, the Assistant Attorney General who regularly acts as counsel to the College and legal advisor to the Board of Trustees, did not take part in the negotiations.

5. At the time of the negotiations, the St. Mary's County Zoning Board had approved development plans for up to six building sites on the Real Estate. The Seller had submitted a revised subdivision plat to the Zoning Board that would have increased the number of building sites, but the Board had not acted on that submission.

6. During the negotiations with the College, the Seller obtained an appraisal of the Real Estate by David G. Whitten (the "Whitten Appraisal"). Mr. Whitten characterized his appraisal as a "restricted report for the benefit of the owner/client" and based his valuation on the assumption that the revised subdivision plat would be approved and that all available building sites could be developed and marketed within one year. On that basis, Mr. Whitten estimated the fair market value of the Real Estate as of September 28, 2007, to be $1,625,300.

7. Mr. Short obtained two appraisals for the College, one by Philip Goldstein (the "Goldstein Appraisal") and one by Margaret Pilkerton Heeney (the "Heeney Appraisal"). Mr. Goldstein initially appraised the property on the assumption that the subdivision plat allowing additional building sites would be approved and estimated the value of the Real Estate to be $1,421,000 as of June 20, 2007. Ms. Heeney valued the property as of June 18, 2007, both on the assumption that the additional sites would be approved and on the assumption that they would not; her estimate of the value with the additional building sites was $1,395,000, and without those sites was $925,000. Both of those appraisals were later revised and updated, at Mr. Short's request, to estimate the as-is value of the property in accordance with the recorded subdivision plat without assigning any value to the additional

building sites in the unapproved subdivision plat. The final Goldstein Appraisal estimated the value of the Real Estate to be $1,106,000 as of October 4, 2007. The final Heeney Appraisal estimated the value of the Real Estate to be $860,000 as of March 11, 2008.

8. The College ultimately agreed to purchase the Real Estate for $800,000, which both parties agreed was less than its fair market value. In preparing the agreement of sale, Mr. Short rejected contract language proposed by the Seller's counsel to the effect that the College endorsed the $1,625,300 valuation in the Whitten Appraisal and considered the value of the donation attributable to the bargain purchase price to be $825,300. On February 5, 2008, the College and the Seller entered into an Agreement of Sale for $800,000, contingent on the College obtaining approval of the purchase from the Maryland Board of Public Works ("BPW").

9. The College submitted a request for approval of the Contract of Sale to the BPW. BPW rules require that a proposal by a State institution to purchase real estate must be supported by two independent appraisals. Mr. Short included with the College's approval request the updated Goldstein Appraisal and the updated Heeney Appraisal. The request did not include or refer to the Whitten Appraisal. The BPW approved the purchase at its meeting on April 30, 2008.

10. The purchase closed on May 6, 2008. The College's Business Office issued a check from the Plant Fund for $804,767.04 to pay the $800,000 purchase price plus $4,767.04 of closing costs. The transaction was recorded on the College's books as a land purchase, and the Real Estate was credited to the College's fixed assets account at its cost of $804,767.04. No revenue or asset value was recorded in the College's books to reflect the bargain element of the purchase.

11. On May 5, 2008, the President of the College sent a letter to the Seller acknowledging the bargain purchase and thanking him for his donation. That letter, which was prepared by the College's Development Office, used the following language to describe the donation:

> We are in possession of your appraisal of $1,625,300 for the above property. The College agreed to a bargain sale price of $800,000, with the remaining $825,300 to be accepted as your gift.

<u>Summary of Findings</u>

Based upon my review of the facts and examination of the relevant documents, my conclusions are as follows:

- There was no collusion or other impropriety in the negotiation of the College's purchase of the Real Estate. Pursuant to advice received from the State Ethics Commission, the Seller took no part in the Board's consideration of the transaction. The purchase terms were negotiated between his attorney and Mr. Short, an experienced real estate attorney from the Attorney General's Office. Mr. Short obtained two independent appraisals of the property, and the purchase price paid by the College was lower than either of those appraisals.

- The College provided the BPW all information that was relevant to the BPW's determination whether acquisition of the Real Estate was a necessary and appropriate expenditure of State funds and whether the purchase price was fair and reasonable. The College's representatives advised the BPW that the transaction was a bargain purchase and provided the College's two independent appraisals. Mr. Short's decision not to refer to the Whitten Appraisal in the approval request was reasonable and appropriate, both because that appraisal was not "independent" and because Mr. Short questioned the validity of certain of the assumptions on which it was based.

- The language used in the College's acknowledgement letter that quantified and accepted the Seller's gift by reference to the Whitten appraisal was the result of the Development Office's good faith attempt to adapt to a bargain purchase the form of letter that it normally used to acknowledge outright gifts of property to the St. Mary's College Foundation. Because the values estimated in the appraisals obtained by the College were substantially lower than the Seller's appraisal, it was inappropriate for the College to quantify the donation in its acknowledgment letter by reference to the Seller's appraisal. However, contrary to the allegation in the draft legislative audit report, the College's acknowledgement letter had no legal or practical significance with respect to the amount of the charitable contribution deduction that the Seller could claim on his Federal and State income tax returns and, therefore, could not have resulted in any loss of tax revenue to the State.

<u>Discussion</u>

A. Purchase Negotiations

The College and the Seller recognized the potential for a conflict of interest in negotiating a transaction with a member of the Board of Trustees. The College sought advice from the State Ethics Commission prior to beginning the negotiations, and the parties followed that advice. The Seller did not participate in the College's consideration of the transaction, and he was represented by his attorney throughout the negotiations with the College. In addition, although the Ethics Commission made no specific recommendation on the point, the College delegated authority to negotiate on its behalf to Mr. Short, an Assistant Attorney General who was experienced in real estate law.

There is no suggestion that the terms of the purchase were disadvantageous to the College. By acquiring the Real Estate, the College avoided residential development just outside the north entrance to its campus and thereby furthered its landscape and setting protection strategy for the campus and the St. Mary's City State historical site. Contrary to the allegation in the draft legislative audit report, the purchase was not "based on an appraisal supplied by the seller." Mr. Short obtained two independent appraisals on the College's behalf, and the price paid by the College was below the fair-market value determined by both of those appraisals.

In my opinion, the purchase negotiations were free of any conflict of interest and resulted in a <u>bona</u> <u>fide</u> bargain purchase that benefited the College.

B. BPW Approval

Most donations of property for the benefit of the College are outright gifts. Such gifts are normally made to the St. Mary's College Foundation, which was formed in 1972 to receive and administer public contributions to the College and to manage the College's endowment. Because the Seller's donation in the form of a bargain purchase of real property entailed an expenditure of funds by the College, the contract to purchase the Real Estate was entered into by the College on behalf of the State of Maryland, not by the Foundation, and required approval by the Maryland Board of Public Works.

The two issues that the BPW considers in deciding whether to approve a real estate purchase by a State institution are whether the proposed acquisition is a necessary and appropriate expenditure of State funds and whether the amount paid for the property is fair and reasonable. BPW approval is not required for a gift of property, nor does the BPW have to approve the amount of the donation that is attributable to a bargain purchase.

In the request for BPW approval, the College's representatives provided the Board all of the information required for its approval process, including a description of the property, an explanation of how acquisition of the property would benefit the College, the purchase price and proposed source of funds for the purchase, and the appraised value as determined by two independent appraisers. At the hearing before the BPW, the College's representatives described the transaction as a bargain purchase from a trustee of the College and explained that the purchase price was less than either of the independent appraisals that the College had obtained. In response to a question from the Maryland Comptroller, they confirmed that the College had no plans to build on the land and that the College's primary purpose for acquiring the Real Estate was to avoid residential development at the north entrance to the College and thereby preserve the setting and the green space contiguous to the campus and the St. Mary's City historical site.

Mr. Short decided that it would be inappropriate to submit or rely on the Whitten Appraisal in the BPW approval process. Because that appraisal was obtained by the Seller, it did not qualify as an "independent" appraisal that the BPW could properly consider in its determination of the reasonableness of the proposed purchase price. In addition, based on his review of the relevant land records and consultation with one of the College's independent appraisers, Mr. Short questioned the validity of Mr. Whitten's assumption that the revised subdivision plot would be approved by the County Zoning Board.

In my opinion, there is no merit to the allegation in the draft legislative audit report that the Whitten Appraisal should have been disclosed to the BPW so the Board could consider the amount of the donation. The BPW is not called upon to approve donations, and the Whitten Appraisal was not relevant to the Board's assessment of the appropriateness of the proposed land acquisition or the reasonableness of the agreed purchase price.

C. Acknowledgement Letter

When the St. Mary's College Foundation receives an outright gift of property, there is no reason for it to obtain an appraisal to determine the amount of the donation. Like other public charities, it simply sends a form letter confirming receipt of the property and thanking the donor for his or her generosity. If the donor provides an appraisal of the property, the acknowledgement letter refers to a donation in the amount of the appraised value.

Congress and the Internal Revenue Service are aware that charitable organizations have no requirement or incentive to make an independent determination of the value of donated property and that they routinely accept and acknowledge donations of property based upon the donor's valuation. In order to prevent overstatement of tax deductions by virtue of this common practice, Congress amended the Internal Revenue Code in 1984 to make the donee's valuation of donated property legally irrelevant to the amount of the charitable contribution deduction the donor is permitted to claim.[2] A donor wishing to claim a deduction for a gift of property must obtain from the donee organization a signed acknowledgement on IRS Form 8283, Part IV, confirming receipt of the gift. The donee is under no obligation to determine or acknowledge the value of the gift. If the donee chooses to determine a value for the gift, the donor is not entitled to claim a charitable deduction based on the donee's valuation. In order to claim a deduction in excess of $5,000 for a donation of property, the donor must obtain a "qualified appraisal" of the value of the property as of a date not more than 60 days prior to the gift and attach to his or her federal income tax return a statement, signed by the appraiser, confirming that the appraisal satisfies the qualified appraisal requirements. <u>See</u> Treasury Regulation § 1.170A-13(c). If the amount of the claimed deduction is more than $500,000, the donor must also attach the entire qualified appraisal to his or her tax return. <u>See</u> Internal Revenue Code § 170(f)(11)(E).

The College's May 5, 2008, letter acknowledging its bargain purchase of the Real Estate was drafted by Torre Meringolo, who was at the time the College's Vice President of Development. Mr. Meringolo is familiar with the Treasury Regulations governing charitable contribution deductions for gifts of property, and the Development Office regularly prepares letters to donors acknowledging donations of property to the Foundation. However, there was no Development Office form letter that Mr. Meringolo could use as a template for the acknowledgement letter to the Seller because, unlike the usual outright donations of property to the Foundation, the Real Estate was acquired by the College in a bargain purchase. Therefore, Mr. Meringolo adapted the form letter the Foundation uses to acknowledge donations of property.

The acknowledgment letter that Mr. Meringolo prepared for the President's signature identified the Real Estate and confirmed that the College had acquired it for a bargain purchase price of $800,000. The letter then referred to the Seller's valuation of $1,625,300, which it made clear was based on an appraisal obtained by the Seller, and "accepted" the excess of the Seller's appraised value

[2] Because an individual's Maryland taxable income is determined by making limited adjustments to the adjusted gross income and itemized deductions reported on his or her federal tax return, the Internal Revenue Code's rules for claiming charitable deductions on an individual's federal tax return directly determine the amount of the Maryland tax benefit as well.

over the purchase price -- $825,300 -- as a gift. In light of the fact that the College had obtained its own appraisals that estimated substantially lower values for the Real Estate, it was inappropriate for the College to describe the value of the donation by reference to the Seller's appraisal. The College should have either refrained from stating a value for the donation or stated a value consistent with its appraisals.

Contrary to the allegation in the draft legislative audit report, however, the College's acknowledgment letter did not "create" an $825,300 donation to the College. In fact, the College did not record any donation. It reflected the transaction on its books as a purchase of the Real Estate for $804,767.04 and did not book any additional revenue or asset value attributable to the bargain purchase price. Nor could the acknowledgement letter have been used by the Seller as the basis for a charitable contribution claim. The letter explicitly stated that the amount of the donation was based on the appraisal provided to the College by the Seller. Moreover, even if the letter could be read as a validation of that donation amount by the College, the amount that a donee organization "accepts" has no legal relevance to the donor's allowable charitable deduction. The only permissible support for a deduction over $500,000 attributable to a donation or bargain sale of property is a qualified appraisal attached to the donor's federal income tax return for the year in which the deduction is claimed.

In my opinion, there is no basis in law or fact for the statement in the draft audit report that the "creation of a charitable donation" by the College "creates the potential for lost revenue if the donation is claimed by the seller in subsequent tax returns." No charitable donation was created. The College merely confirmed receipt of the Real Estate and the purchase price it paid and acknowledged the Seller's valuation of the bargain-sale donation. Nor is there any risk that the College's acceptance of the Seller's valuation could result in lost tax revenue. Whatever amount the Seller claimed as a deduction on his tax return had to be supported by the Seller's qualified appraisal, and whether that deduction is allowed will depend entirely on the validity and reasonableness of that appraisal.

Conclusion

The College's representatives acted lawfully and in the College's best interest throughout the process of negotiating the purchase and obtaining a BPW approval. The inappropriate language in the College's acknowledgment letter did not reflect any intentional wrongdoing, much less any criminal violation, on the part of the College or its agents. That language was not intended to create, and could not have created, an unwarranted tax benefit for the Seller. Rather, it was the result of a good-faith attempt to adapt the Development Office's protocol for accepting property donations to the extraordinary circumstance of a bargain purchase.

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Richard Timbie joined Caplin & Drysdale in 1973 and has been a partner in the firm since 1979. Mr. Timbie's practice consists primarily of representing clients in tax controversies. He has more than 35 years of experience in resolving Internal Revenue Service audits, administrative appeals, and collection disputes. He has litigated complex tax cases in the Tax Court and other federal courts and has represented clients in IRS summons enforcement proceedings, trust fund recovery penalty cases, and criminal tax fraud investigations.

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Mr. Timbie is a frequent lecturer on tax procedure and international tax topics. He was an adjunct professor at the Georgetown University Law Center in 1998-2000, where he taught a course in international taxation. He has spoken before numerous tax conferences, including the New York University Institute on Federal Taxation, the Mid-America Tax Institute, the Virginia Tax Institute, the Bank Tax Institute's Annual Conference on International Withholding and Information Reporting, and the George Washington University/Internal Revenue Service Annual Institute on International Taxation. Mr. Timbie is listed in The Best Lawyers in America in the specialty of Tax Law from 2001-2010.

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