The Commonwealth of Massachusetts

AUDITOR OF THE COMMONWEALTH

ONE ASHBURTON PLACE, ROOM 1819

BOSTON, MASSACHUSETTS 02108

TEL. (617) 727-6200

A. JOSEPH DeNUCCI

AUDITOR

NO. 2001-4427-3

INDEPENDENT STATE AUDITOR'S REPORT ON CERTAIN ACTIVITIES OF THE HERITAGE SCHOOL, INCORPORATED JULY 1, 1999 TO FEBRUARY 28, 2001

OFFICIAL AUDIT REPORT
OCTOBER 18, 2001

TABLE OF CONTENTS/EXECUTIVE SUMMARY

The Heritage School, Incorporated (HS) was organized as a not-for-profit corporation in 1975. Currently, HS operates a daycare facility with a regularly enrolled body of students for the purpose of educating preschool children as well as providing kindergarten activities for students in the greater Quincy area. Our audit, which covered the period July 1, 1999 through February 28, 2001, had the following objectives: (1) to determine whether HS established an adequate system of management controls and (2) to assess HS's business practices and its compliance with the applicable laws, regulations, policies, procedures, and various fiscal and programmatic requirements of its contracts with state-funded agencies. Our audit identified a lack of internal controls over many aspects of HS's administrative and financial operations, resulting in at least $45,381 in highly questionable and unnecessary expenditures and at least $12,262 in unrecorded and unpaid liabilities. Also, HS did not file required reports with the Internal Revenue Service (IRS) and other state oversight agencies, contrary to state laws, and did not maintain a Board of Directors to oversee agency operations.

Our review noted that, contrary to state regulations, HS was not maintaining its financial records in accordance with Generally Accepted Accounting Principles. We also found that, contrary to the terms and conditions of state contracts that apply to subcontractors, HS was not maintaining its records for a required seven-year period. As a result, the Commonwealth cannot be assured that the estimated $133,764 in state funding that HS received during our audit period was appropriate or that all agency expenses were reasonable, allowable, and in compliance with applicable laws and regulations. In fact, during the period covered by our audit, we found that, as a result of HS's poor recordkeeping practices, it incurred at least $45,381 in highly questionable and unnecessary expenses and had at least $12,262 in unrecorded and unpaid liabilities.

Our review noted that, contrary to state and IRS regulations, HS had not filed numerous regulatory filings with the appropriate state and federal agencies. For example, during our audit period, HS did not file income information forms (Form 990) with the IRS or annual financial statements (Form PC) with the state's Office of the Attorney General. As a result, these agencies have not been able to effectively monitor HS's activities or assess its performance and compliance with applicable state and federal laws and regulations.

Our review noted that, contrary to state law, HS did not maintain a Board of Directors to oversee its operations. As a result, there were inadequate controls in place to ensure that HS's activities were conducted in an effective and efficient manner and in compliance with applicable laws, regulations, and contractual terms and conditions.

INTRODUCTION

Background

The Heritage School Incorporated (HS) was formed as a not-for-profit corporation in 1975. According to HS's Articles of Organization, the purpose of HS is as follows:

> *The Heritage School was formed in order to operate a facility or facilities on a regular basis with a regularly scheduled curriculum, a regular faculty and a regularly enrolled body of students in attendance at a place or places where educational activities are carried on for the purpose of educating pre-school children and for the purpose of conducting a kindergarten.*

HS currently leases facilities in Quincy, where it provides daycare and kindergarten services to local residents. HS receives funds directly from private pay customers and indirectly from the Office of Child Care Services (OCCS) and the Department of Education (DOE). Families that request state-funded services from HS are first referred to a local resource and referral agency, Quincy Community Action Programs, Incorporated (QCAP), which utilizes state guidelines to screen applicants and to determine program eligibility. If QCAP determines that the applicant is eligible, it places the client at HS. HS bills QCAP for the services it provides to these referred clients, and QCAP gets reimbursed by the appropriate state agency (e.g., OCCS) for the cost of these billings. Although HS receives this funding indirectly from state purchasing agencies, according to state regulations HS is functioning as a subcontractor to QCAP and, therefore, must comply with the same statutory and contractual requirements as service providers who contract directly with state agencies. The following table summarizes the revenues received by HS during our audit period.

Heritage School Inc.
Estimated Revenues
July 1, 1999 through February 28, 2001

Fiscal Year	Office of Child Care Services Vouchers	Department of Education Vouchers	Private Pay Clients	Total
2000	$ 50,752	$16,229	$131,596	$198,577
2001	57,694	9,089	87,730	154,513
Total	$108,446	$25,318	$219,326	$353,090

During the period of our audit, HS was not maintaining accurate and complete financial records as required by state regulations (see Audit Result No. 1). Thus, the revenue amounts indicated are estimates made by the audit team based on available agency data and may not include all revenue.

Audit Scope, Objectives, and Methodology

The OCCS contacted the Office of the State Auditor (OSA) regarding concerns it had relative to questionable expenditures and financial practices at HS. Based on these concerns, the OSA initiated an audit of HS. The scope of our audit was to examine selected financial and operational activities of HS for the period July 1, 1999 through February 28, 2001. Our audit was conducted in accordance with applicable generally accepted government auditing standards for performance audits and included audit procedures and tests that were considered necessary. Our specific objectives were to:

- Assess management control systems to determine whether management's recording, reporting, and monitoring of financial activity was adequate to ensure that resources are adequately safeguarded and are being used economically and efficiently.
- Determine HS's compliance with applicable laws, rules, and regulations; including processes for planning, organizing, directing, and controlling program operations.

In order to achieve our objectives, we assessed the system of management controls established and implemented by HS over its operations. The purpose of this assessment was to obtain an understanding of management's attitude, the control environment, and the flow of transactions through HS's accounting system. This assessment was used in planning and performing our audit tests. We reviewed HS's administrative documents, including internal policies and procedures. We then reviewed applicable laws and regulations and examined billings, invoices, and other pertinent financial records to determine whether expenses incurred under the school's voucher reimbursements were reasonable; allowable; allocable; properly authorized and recorded; and in compliance with applicable laws, rules, and regulations. Our review was not made for the purpose of forming an opinion on HS's general-purpose financial statements. We also did not assess the overall quality and appropriateness of program services being provided by HS.

During our audit engagement, the President of HS conducted activities that limited the OSA's ability to perform audit testing. As a result, the timeliness of the audit work performed was affected, and the OSA was prohibited from applying all of the audit procedures considered necessary. Specifically, the OSA is authorized by its enabling legislation, Chapter 11, Section 12, of the Massachusetts General Laws, to perform audits of entities such as HS that receive funding from the Commonwealth to determine compliance with the provisions and requirements of such contracts or agreements and the laws of the Commonwealth. Specifically, Chapter 11, Section 12, of the General Laws states, in part:

> *The state auditor shall have access to such records at reasonable times and said department may require the production of books, documents, vouchers, reports, and other records relating to any matter within the scope of such audit.*

Additionally, regulations promulgated by the Commonwealth's Operational Services Division (OSD), the agency responsible for regulating the activities of service providers and their subcontractors such as HS, require service providers to provide all records needed by the OSA as well as other organizations to complete an audit of the agency. Specifically, 808 Code of Massachusetts Regulations 1.04(8), effective February 8, 2000, states, in part:

> *A Contractor shall make available for review, inspection and audit all records relating to its operations and those of its affiliates, subsidiaries and Related Parties and shall permit timely and reasonable access to its appropriate personnel for the purpose of interview and discussion related to those records and associated policies to any contracting Department, Executive Office, DPS, the Office of the State Auditor, the federal government or their representatives.*

Despite these statutory requirements, during the conduct of our audit fieldwork, HS did not make all of its records available to the audit staff at reasonable times. Specifically, HS did not provide us with a General Accounting Ledger that detailed all of its financial transactions for the audit period, nor did agency officials provide us with any financial statements or bank reconciliations for the entire audit period. In addition, HS could not provide us with any bank statements for the period December 2000 and January 2001. Finally, during our audit, HS's President removed a computer from HS that contained records of many of HS's financial activities and took it to her home.

As a result of these problems, our ability to perform sufficient audit testing was impaired, and the audit results and opinions expressed in this report are based solely on the limited documentation HS was able to provide to the audit team. Given the seriousness of the limitations we encountered and the highly questionable nature of many of the expenses we were able to examine, we are forwarding this report to the appropriate state regulatory and oversight agencies for their review, action, and resolution.

AUDIT RESULTS

1. NONCOMPLIANCE WITH STATE REGULATIONS AND CONTRACT TERMS AND CONDITIONS RELATIVE TO THE MAINTENANCE OF FINANCIAL RECORDS

Our review of the Heritage School, Inc., (HS) noted that, contrary to state regulations, HS was not maintaining its financial records in accordance with Generally Accepted Accounting Principles (GAAP). Our review also found that, contrary to the terms and conditions of state contracts that apply to subcontractors, HS was not maintaining its records for a required seven-year period. As a result, the Commonwealth cannot be assured that the estimated $133,764 in state funding that HS received during our audit period was appropriate or that all agency expenses were reasonable, allowable, and in compliance with applicable laws and regulations. In fact, we found that as a result of HS's poor recordkeeping practices, HS incurred at least $45,381 in highly questionable and unnecessary expenses and had at least $12,262 in unrecorded and unpaid liabilities.

The state's Operational Services Division (OSD) promulgated regulations with which all human service providers and their subcontractors that receive state funding, such as HS, must comply. Regarding the maintenance of financial and other records, 808 Code of Massachusetts Regulations (CMR) 1.04 (1) states, in part:

> *The Contractor and its Subcontractors shall keep on file all data necessary to satisfy applicable reporting requirements of the Commonwealth (including DPS, the Division of Health Care Finance and Policy and Departments), and financial books, supporting documents, statistical records, and all other records which reflect revenues associated with and costs incurred in or allocated to any Program of services rendered under the Contract. The Contractor and its Subcontractors shall maintain records of all types of expenses and income or other funds pertaining to the Program paid to the Contractor by every source, including from each Client. Books and records shall be maintained in accordance with generally accepted accounting principles as set forth by the American Institute of Certified Public Accountants (AICPA); which for not-for-profit Contractors shall be the Industry Audit Guide for Audits of Voluntary Health and Welfare Organizations, unless otherwise provided in the UFR. In addition, personnel records shall be maintained for each employee in accordance with generally accepted accounting principles recommended by the AICPA and sufficient to meet the requirements of M.G.L. c. 151, the Fair Labor Standards Act of 1938 and contract terms. . . .*

In addition, the state's Executive Office for Administration and Finance and OSD have promulgated the Commonwealth Terms and Conditions for Human and Social Services (General Contract Conditions), with which all human service providers and their subcontractors who receive state funds such as HS must comply. Regarding the maintenance of records, these General Contract Conditions state, in part:

> *<u>Record-keeping And Retention, Inspection Of Records.</u> The Contractor shall maintain records, books, files and other data as required by 808 CMR 1.00 and as specified in a Contract and in such detail as shall properly substantiate claims for payment under a Contract, for a minimum retention period of seven (7) years beginning on the first day after the final payment under a Contract, or such longer period as is necessary for the resolution of any litigation, claim, negotiation, audit or other inquiry involving a Contract. . . .*

Moreover, OSD in 808 CMR 1.05(26) identifies the following as a nonreimbursable cost under state contracts:

> *<u>Undocumented Expenses</u>. Costs which are not adequately documented in light of the American Institute of Certified Public Accountants statements on auditing standards for evidential matters.*

During our audit, we found that, contrary to OSD regulations, HS was not maintaining its financial records and did not have a comprehensive accounting system that allows for the preparation of accurate and auditable financial statements in accordance with GAAP. Further, HS's accounting system did not effectively collect, record, compile, and summarize financial transactions because it did not maintain a general accounting ledger that details this information. Additionally, HS did not prepare periodic budgets of revenues and expenses, nor did it have a system to control the authorization and payment of expenditures. Rather, HS used a checkbook to record all agency expenses and revenues, and this checkbook was maintained by one individual, HS's President. As a result of these poor internal controls, there is inadequate assurance that the funds received by HS were appropriate or that its expenditures were reasonable and allowable.

We selected a sample of $63,574 from HS's total expenditures of $324,618[1] during the period July 1, 1999 through February 28, 2001. However, because HS officials were not able to provide us with bank statements and cancelled checks for the months of December 2000 and January 2001, our audit testing in this area was limited. Therefore, our test of expenditures did not include any expenses incurred by HS during these two months.

Based on our review of the documentation that was being maintained by HS relative to these transactions, we found issues with various expenses and liabilities, as follows:

a. Undocumented and Highly Questionable Expenditures Totaling $44,069

Our review identified $44,069 in undocumented and highly questionable expenditures. All these expenditures were made by the President of HS, who had sole control of the checking account as well as the Automated Teller Machine (ATM) card for the checking account. Specifically, this $44,069 in questionable and undocumented expenditures consisted of $28,831 in expenditures paid by check and $15,238 in purchases and cash withdrawals made with an ATM, as follows:

Heritage School, Inc.
Summary of Undocumented and Questionable Expenses
July 1999 through February 2001

Description	Total
Purchases by check	$21,199
Checks made out to the President	7,632
ATM (debit) purchases made by the President	6,090
ATM cash withdrawals by the President	9,148
Totals	$44,069

Despite numerous requests, HS's President was not able to provide us with any documentation to substantiate the nature of these expenses. In fact, our review noted some examples of unusual transactions, as follows:

[1] This amount is an estimate from HS's bank statements that were made available and may not include all expenditures.

- A total of $2,300 in checks were made payable to HS's President within a three-day period from March 30, 2000, to April 1, 2000, with no explanation as to the nature of these expenses.

- ATM cash withdrawals totaling $794 were made by HS's President over a three-day period with no explanation as to the nature of these expenses.

- Two ATM withdrawals totaling $204 were made on the same day by HS's President in New Hampshire with no explanation as to the nature of these expenses.

Because HS could not provide any documentation supporting the business nature of the $44,069 in expenditures, these costs are considered nonreimbursable costs in accordance with OSD regulations.

b. Poor Internal Controls over Checking Account Funds Resulted in $1,312 in Insufficient Fund Fees

As previously noted, HS uses one primary checking account in which it records agency revenues and expenses. Our review of this bank account revealed that it had not been reconciled during the entire 20-month period covered by our audit. Since HS had not performed a reconciliation of this account, it was not possible for HS's management to establish its actual cash position at any point in time. In fact, we noted that during our audit period, the President wrote 42 checks that were drawn on this checking account when there were insufficient funds available to cover these checks. As a result, HS incurred $1,312 in insufficient fund charges for these 42 checks. Because HS did not implement bank reconciliation procedures, which could have prevented the $1,312 in insufficient funds charges, these costs were unreasonable and are considered nonreimbursable costs in accordance with OSD regulations, which prohibit interest, penalties, or other fines from being charged against state contracts.

Regarding these matters, HS's President stated that she did not believe it was necessary to perform bank reconciliations because, in her opinion, there would always be enough revenue to pay agency expenses. She also stated that she believed that the late fees were "necessary business expenses."

c. Unrecorded and Overdue Accounts Payable Totaling $12,262

We reviewed all the available documentation that HS maintained relative to bills it had received during the audit period to determine the extent to which agency bills remained unpaid. As previously mentioned, HS uses a checkbook to record its revenues and expenses and does not maintain any other accounting records that would identify outstanding accounts receivable or accounts payable.

Based on our review, we identified a significant unrecorded liability of HS due to the Massachusetts Department of Revenue (DOR) for payroll taxes. The original amount of funds owed to DOR by HS, totaling $6,739, was for 12 months of state income tax withholdings that were not paid during the period June 1997 through July 1998. HS established a payment plan with DOR to pay this $6,739, but it did not adhere to this payment schedule. As a result of HS's noncompliance with the payment plan, the total amount owed to DOR, including penalties and interest due, as of the end of an audit period had increased to $9,195. The documentation maintained by HS did not indicate how much of this $9,195 amount accrued was interest and penalties. However, in accordance with 808 CMR 1.05(3)(d), any interest and penalties paid as a result of this outstanding liability would be an unallowable expense. Specifically, 808 CMR 1.05(3)(d), identifies the following as nonreimbursable costs:

> *Any interest or penalties incurred because of late payment of loans or other indebtness, and payment of late filing of federal and state tax returns, municipal taxes, unemployment taxes, social security, and the like.*

Finally, we also found an unrecorded liability of $3,067 that HS owed the landlord of the property it was using to house its administrative office and program site. The landlord, the Quincy Point Congregational Church (QPCC), terminated its lease with HS effective August 2001. QPCC's Treasurer informed us that HS at that time owed $3,067 in unpaid rent, as follows:

Month	Unpaid Rent Amounts
July 2000	$ 667
August 2000	800
November 2000	800

March 2001	800
Total	$3,067

HS's President could not explain why these liabilities had not been paid.

Recommendation

HS should immediately implement an accounting system that is consistent with the requirements of OSD regulations and GAAP. Moreover, HS should ensure that it maintains its records for a period of seven years as required by state regulations and should establish better controls over the authorization and payment of agency expenses. At a minimum, such controls should include implementing a purchase order system so that the need for all purchases are properly documented; maintaining invoices/receipts for all purchases that clearly indicate the business nature of each expense; and requiring dual authorization for all expenses over a specified amount. Further, HS's checking account and bank statements should be reconciled to its General Ledger on a monthly basis. Also, HS should immediately take measures to ensure that it pays all of its outstanding liabilities in a timely manner.

Because of the inadequate records maintained by HS, it could not be determined what amount of state reimbursements was used by HS to pay for the $44,069 in highly questionable expenses and the $1,312 in unnecessary expenses. Since HS received an average of approximately 38% of its revenues from state agencies ($133,764 in state vouchers/$353,090 in total estimated revenue), it is a reasonable estimate that HS should remit to these agencies $17,245 ($45,381 x .38). However, the Office of Child Care Services (OCCS) should conduct a review of the documentation HS is maintaining relative to the $45,381 in expenses and, based on this review, determine the appropriate amount to be reimbursed by HS. Further, OCCS should ensure that no state funds are used to pay fines, penalties, or interest charges on the outstanding liability HS owes DOR. In addition, OCCS, in conjunction with other state regulatory and law enforcement agencies, should conduct a review of expenditures made by HS for the period prior and subsequent to the period covered by our audit and take whatever measures necessary to resolve this matter.

Auditee's Response

In response to this audit result, HS's President provided written comments, which are paraphrased below:

- HS did not have many of the records the audit team requested on site due to numerous break-ins that the school had encountered.
- The President took the agency computer home so she could work at home while her son recuperated from an illness.
- All the expenses questioned in the report were documented either by a receipt or in the memo random section of the agency check book, in monthly journal records, or on bank statements. Also, the President pointed out that she was not the only HS employee who was authorized to use the agency debit card and check book.
- The non-payment of payroll tax occurred long before HS's current President became employed at the Heritage School. Generally payments to DOR were not missed unless arrangements were made with DOR.
- The rent for space was paid on time.
- HS has purchased a new software program that contains an interfacing accounting system and will also be hiring a fee accountant to assist in agency accounting activities.

Auditor's Reply

As stated in our report, during the conduct of our audit fieldwork, HS did not make all of its records available to the audit staff at reasonable times. Specifically, HS did not provide us with a General Accounting Ledger that detailed all of its financial transactions for the audit period, nor did agency officials provide us with any financial statements or bank reconciliations for the entire audit period. In addition, HS could not provide us with any bank statements for the periods December 2000 and January 2001. Finally, during our audit, HS's President removed a computer from HS that contained records of many of HS's financial activities and took it to her home. If, in fact, as HS's President implies in her response, these records existed but were being maintained off-site because of numerous break-ins the agency had experienced, HS should have informed us of this fact during the conduct of the audit and made the requested records available to the audit staff. Since despite repeated requests, this information was not provided to the audit staff, we can only assume that it does not exist, and have therefore appropriately noted this deficiency in our report.

Regarding the $45,381 of questionable expenditures, as noted in our report, HS did not provide us with sufficient documentation to substantiate the business nature of these expenses. While notations in the memorandum section of a checkbook or a journal entry or bank statement may indicate the date and type of a particular expense, such notations are not sufficient to document the business nature and appropriateness of such expenses. Acceptable documentation at a minimum would consist of invoices or receipts for the goods or services purchased. However, since HS could not provide any receipts or invoices relative to these expenses, they are clearly inadequately documented and questionable.

Regarding other agency staff who had authority to use the agency debit card and checking account, during our audit we identified only one other HS employee, the school's Program Director, who was authorized to use this card and write checks. This individual stated that she was made a signatory on the agency's checking account in November 2000 but was removed as a signatory on this account by the agency's President on December 6, 2000. She added that, during this brief period, she never signed a check or used the agency debit card. Further, our audit testing did not indicate any instances in which the Program Director authorized a check or used the agency debit card. Consequently, HS's President was, in effect, the only individual who appeared to have conducted the transactions in question.

While the non-payment of employee withholding taxes did begin prior to the current President's assumption of duties, as of the end of our audit field work, the agency still had not fully repaid its outstanding liabilities. Moreover, the agency's accounting system was not identifying these liabilities so that they could be paid in a timely manner. Clearly, it is management's responsibility to ensure that agency expenses are paid in a timely manner.

Moreover, contrary to what HS states in its response, the agency did not pay its rent in a timely manner. To support its assertion that it paid its rent on time, in its response HS attached a letter from its landlord dated November 18, 2000. However, this letter supported our position that HS was not paying rent in a timely manner by stating, in part, "This check was the rent for August 1999… you still owe the Church rent for the months of July and August, 2000." Further, according to HS's President, subsequent to the end of audit field work, HS negotiated with its landlord to: (1) leave certain furniture and fixtures on site in lieu of back rent due and (2) apply HS's security deposits to the outstanding balance of rent due the landlord. According to HS's President, this still left an adjusted rent payable of $417.

However, in subsequent communications, we were subsequently informed by QPCC that (1) no security deposit was given to QPCC by HS, and thus such a deposit could not be credited to outstanding rent; (2) HS was informed that no credits for furniture, etc., would be deducted from HS back rent; and (3) according to QPCC records, the outstanding rent from HS had increased from $3,067 as stated in our report to $7,067 as of August 1, 2001. Additionally, in its response to our audit, HS stated that the balance due for rent was $457. However, QPCC records indicate a balance owed of $7,067, a difference of $6,610. QPCC has established a September 13, 2001 court action to collect the outstanding amount and to evict HS.

Finally, we believe the actions taken by HS relative to improving the agency's accounting controls as detailed in the agency's response were necessary. However, given that they were being implemented subsequent to the end of our audit we cannot comment on their adequacy.

2. REQUIRED INCOME TAX AND REGULATORY STATEMENTS NOT FILED

Our review noted that, contrary to state and Internal Revenue Service (IRS) regulations, HS did not file numerous regulatory filings with the appropriate state and federal agencies. For example, during our audit period, HS did not file income information forms (Form 990) with the IRS or annual financial statements (Form PC) with the state's Office of the Attorney General (OAG). As a result, these agencies have not been able to effectively monitor HS's activities or assess its performance and compliance with applicable state and federal laws and regulations.

Nonprofit organizations that do business within the Commonwealth are required to file various reports with Commonwealth agencies and the IRS. These reports are used by these regulatory agencies to assess each organization's activities and ensure that they comply with applicable state and federal regulations. During our audit, we found that HS did not file numerous required reports as detailed below:

a. HS Did Not File IRS Form 990

HS was granted a not-for-profit corporation status under IRS Code Section 501(c)(3) and is required by this section to annually file and IRS Form 990 entitled, "Return of Organization Exempt from Income Tax." This form discloses various information, including the annual financial activities of an organization, and lists of officers, directors, trustees, and key employees. According to the IRS Instructions for Form 990, this form is to be filed by the 15th day of the fifth month after the organization's accounting period ends. According to IRS Code Section 6652(c)(1)(A), any organization that does not file this form is subject to the following penalties:

> *A penalty of $20 a day, not to exceed the smaller of $10,000 or 5% of the gross receipts of the organization for the year, may be charged when a return is filed late, unless the organization can show that the late filing was due to reasonable cause. The penalty begins on the due date for filing the Form 990 or Form 990-EZ. The penalty may also be charged if the organization files incomplete return or furnished incorrect information.*

We found, however, that HS had not filed a Form 990 for fiscal years 1999 and 2000. By not filing this form, HS has subjected itself to the above-mentioned penalties and is jeopardizing its financial viability. Regarding this matter, HS's President stated that she was unaware that these forms needed to be filed.

b. HS Did Not File Financial Reports to OSD

According to OSD guidelines, organizations that receive less than $100,000 in state funds are not required to file a complete Uniform Financial Statement and Independent Auditor's Report (UFR). However, HS is required to provide OSD with certain information, as follows:

> *A completed UFR cover page and documentation to support the exemption must be submitted. Acceptable documentation includes the following: Financial statements prepared and audited in accordance with GAAP and GAAS or an accountant's report in reviewed financial statements prepared by an independent auditor in accordance with AICPA Statements and Standards for Accounting and Review Services. . . .The documentation noted above must itemize revenue from the Commonwealth. Other reliable documentation that itemizes revenue for the Commonwealth, such as a federal tax return or Form PC, is also acceptable.*

OSD requires that this information be received by the 15th day of the fifth month after the end of the vendor's fiscal year. OSD's 808 CMR 1.04 11(b) states that vendors who do not obtain and deliver an annual audit to OSD: May be subject to penalties up to and including:

> *Delay of payment, disallowances of payment of expenses relative to which documentation sufficient to meet the governmental agencies' inspection or auditing standards is not provided, restriction on bidding for new contracts, restriction from receiving additional funds or price increases, determination that the Contractor is ineligible for the ready payment system under 815 CMR 3.00, or debarment from doing business with the State.*

However, we found that HS did not file these documents with OSD for fiscal years 1999 or 2000. Regarding this matter, HS's President stated that she was unaware that these financial statements had to be filed and that HS had never filed this information with OSD.

c. HS Did Not File Massachusetts Annual Public Charities Reports Form PC

The state's OAG requires, under Chapter 12, Section 8F, of the General Laws, that every public charity file an annual financial report (Form PC) with the OAG's Division of Public Charities. The key information required by Form PC is as follows:

- Organizational Data
- Summary of Financial Data
    - ❖ Revenues
    - ❖ Expenses
    - ❖ Fund Balance
- Organizational Structure (Corporation/Unincorporated)
- Key Officer Compensation

- Related-Party Activity
- Fund Solicitation Activities

For organizations that have less than $250,000 in annual gross revenue, the financial statements submitted must be accompanied by an certified public accountant's review report. Chapter 12, Section 8F, of the General Laws provides for penalties to be levied against corporations that do not file this report by stating, in part, "The division may bring an action to restrain the charity from transacting any business in the commonwealth." During our audit we determined that, as of the end of our audit period, the OAG's Division of Public Charities had no record of HS's ever filing a Form PC.

Regarding this matter, the President of HS told us that she was unaware that this report had to be filed with the OAG.

Recommendation

HS should file all relevant financial and tax documents with the appropriate federal and state agencies for fiscal years 1999 and 2000 and for any other year that it has not filed these reports. Further, HS should take measures to ensure that in the future, all required reports are filed with the appropriate state and federal agencies in a timely manner.

Auditee's Response

In response to the audit result, HS's President provided comments that are paraphrased as follows:

> The agency will take measures to prospectively file all required reports and will file all past overdue reports by September 30, 2001.

3. LACK OF A BOARD OF DIRECTORS TO OVERSEE AGENCY OPERATIONS

Our review noted that, contrary to state law, HS did not have a Board of Directors to oversee its operations. As a result, there were inadequate controls in place to ensure that HS's activities were being conducted in an effective and efficient manner in compliance with applicable laws, regulations, and contractual terms and conditions.

Chapter 156B, Section 47, of the General Laws states, in part: "The business of every corporation shall be managed by a board of directors." The Board of Directors of a public service agency is the primary organizational body that ensures the agency meets its operational objectives in the most effective and efficient manner. Board members perform a variety of key functions, including overseeing the overall operation of the agency, setting policies and procedures to ensure that agency objectives are met, and hiring the agency's top executive.

The state's OAG issued a publication entitled, "The Attorney General's Guide for Board Members of Charitable Organizations." This booklet details the financial responsibility of board members of charitable organizations, by stating, in part, as follows:

> *As a board member you have primary responsibility for making sure that the charity is financially accountable, has mechanisms in place to keep it fiscally sound, operates in a fiscally sound manner, and is properly using any restricted funds it may have.*
>
> *This means:*
>
> *The board should make sure that a realistic annual budget is developed.*
>
> *The budget should be developed early enough so that the entire board can be involved in its review and approval before the beginning of the fiscal year.*
>
> *The board should be sure that the charity has adequate internal accounting systems.*
>
> *Board members should expect management to produce timely and accurate income and expense statements, balance sheets and budget status reports and should expect to receive these in advance of board meetings.*
>
> *The board should require periodic confirmation from management that all required filings (such as tax returns and the Massachusetts Form PC) are up-to-date and that employee withholding taxes and insurance premiums are being paid when due.*
>
> *The board should consider the value of maintaining standing audit and finance committees.*

During our audit, we requested from HS's President all the documentation being maintained by the agency, including minutes of HS's Board of Directors meetings, that detailed the actions taken by the Board of Directors during our audit period. However, HS's President was unable to provide us with any documentation to substantiate that HS's Board of Directors conducted activities during the entire period covered by our audit. In fact, HS's

President informed us that her attorney advised her to dissolve HS's Board of Directors, which she did in August 2000. The President also stated that her attorney was drafting new corporate bylaws because the current set were "antiquated and old." However, she could not provide us with a copy of HS's current corporate bylaws or any documentation indicating that the President's attorney had advised her to dissolve HS's Board of Directors. Because HS's President could not provide us with a copy of its corporate bylaws, the duties and responsibilities of HS's Board of Directors could not be determined and HS's compliance with its bylaws could not be assessed.

As a result, HS no longer has a Board of Directors, contrary to Chapter 156B, Section 47, and Chapter 180, Section 3, of the General Laws. Moreover, there are inadequate controls in place to ensure that agency objectives are met in an efficient and effective manner consistent with the requirements of applicable state and federal laws and regulations. In fact, as detailed in Audit Results No. 1 and No. 2, there were several questionable activities conducted by HS's management that may have been avoided if the agency still utilized a Board of Directors to oversee its operations.

Recommendation

HS should take measures to immediately establish a Board of Directors, in accordance with the General Laws. In addition, HS's Board of Directors should elect officers; set overall corporate policy; hold regular meetings, including an annual meeting to elect officers; and keep minutes of these meetings, which should be signed and dated by the Clerk of the Board. Moreover, HS should ensure that it fully complies with its corporate bylaws and that any changes to its bylaws are approved by its Board of Directors and the OAG.

Auditee's Response

In response, HS's President provided comments that are paraphrased below:

> The agency has rewritten its corporate bylaws and is making an attempt to add members to its Board of Directors. However, to date the agency has not received any responses to its soliciation for board members.

Auditor's Reply

We again recommend that HS continue to take all the necessary measures to immediately establish a Board of Directors in accordance with the General Laws. Should parents of students not show interest in participating on the board, then HS should consider further modifying its corporate bylaws to allow for the election of non-parents to its Board of Directors. Moreover, HS's Board of Directors should elect officers; set overall corporate policy; hold regular meetings, including an annual meeting to elect officers; and keep minutes of these meetings, which should be signed and dated by the Clerk of the Board. Also, HS should ensure that it fully complies with its corporate bylaws and that any changes to its bylaws are approved by the Board of Directors and the OAG.