The Commonwealth of Massachusetts

AUDITOR OF THE COMMONWEALTH

ONE ASHBURTON PLACE, ROOM 1819
BOSTON, MASSACHUSETTS 02108

A. JOSEPH DeNUCCI
AUDITOR

TEL. (617) 727-6200

2004-4484-3C

INDEPENDENT STATE AUDITOR'S REPORT ON CERTAIN ACTIVITIES OF THE NEW ENGLAND HUMAN SERVICES, INC. D/B/A RIVERSIDE SCHOOL JULY 1, 2001 THROUGH MARCH 31, 2004

OFFICIAL AUDIT REPORT

JANUARY 9, 2006

TABLE OF CONTENTS/EXECUTIVE SUMMARY

INTRODUCTION 1

New England Human Services, Inc., DBA Riverside School (Riverside), was founded in 1980 as a for-profit organization for the purposes of operating a school or schools for students with special needs. In May of 1991, Riverside entered into an agreement, effective July 1991, to take over the operations of Institute Day School Inc., which operated a school for special needs students. In July of 1991, Riverside incorporated under the provisions of Chapter 180 of the Massachusetts General Laws as a not-for-profit organization for the purposes of operating a school for emotionally disturbed children and providing educational, training, rehabilitative and residential services for emotionally disturbed, mentally ill, mentally retarded, and disabled individuals.

Riverside is an approved private special education school, and its residential program is licensed by the state's Office of Child Care Services as a 58-bed program servicing a male population between the ages of 7 and 16. Riverside's educational and administrative facilities are located in Lowell, and are leased from an affiliated for-profit organization, Institute Associates of Lowell (IAL).

The scope of our audit included an examination of certain administrative and operational activities of Riverside during the period July 1, 2001 to March 31, 2004. Our audit was conducted in accordance with applicable generally accepted government auditing standards for performance audits issued by the Comptroller General of the United States. The objectives of our audit were to (1) determine whether Riverside had implemented effective internal controls and (2) assess Riverside's business practices and its compliance with applicable laws, rules, and regulations and the various fiscal and programmatic requirements of its state contracts.

Our audit identified $1,772,896 in questionable and unallowable expenses that Riverside billed to its state-funded contracts during the audit period. We also found inadequate oversight by Riverside's Board of Directors and inadequate internal controls over many aspects of Riverside's operations.

AUDIT RESULTS 5

1. RIVERSIDE ENGAGED IN UNALLOWABLE RELATED-PARTY TRANSACTIONS TOTALING AT LEAST $430,669 AND DID NOT FULLY DISCLOSE THREE RELATED-PARTY TRANSACTIONS 5

We found that, contrary to state regulations, Riverside used state funds to make payments for the rental of property from IAL, a company owned by Riverside's Executive Director, that exceeded the amount allowed by state regulations by at least $430,669. Under these lease agreements, in lieu of making a specified dollar amount as a lease payment, Riverside agreed to pay for all the expenses associated with the operation of this property, (commonly known as a "triple net lease") including mortgage principal and interest payments; property taxes; utilities, maintenance, and repair expenses; and at least $432,646 in capital improvements, of which $259,267 was charged by Riverside

against its state contracts. Of particular concern is that, according to representatives of Riverside's private accounting firm, beginning in fiscal year 2001, Riverside also provided its related party, IAL, with an additional $33,000 per year to pay Riverside's Executive Director's personal income tax liability that resulted from the profits he made from leasing this space to Riverside. We also found that, contrary to state regulations, Riverside did not adequately disclose in the financial statements it filed with the Commonwealth three other related-party transactions during our audit period. By not disclosing these transactions, Riverside did not provide its state and other funding agencies, as well as other users of this financial information, with all of the information necessary to assess Riverside's operations.

2. RIVERSIDE'S EXECUTIVE DIRECTOR USED $348,623 IN STATE FUNDS TO PURCHASE LIFE INSURANCE POLICIES FOR HIMSELF AND A FORMER BUSINESS ASSOCIATE, WHO WAS NOT AN EMPLOYEE OF RIVERSIDE 20

During fiscal years 2002 through 2004 (through March 31, 2004), Riverside used $348,623 in state funds to purchase life insurance policies for Riverside's Executive Director and a former business associate of the Executive Director who was not an employee of Riverside. However, Riverside did not have an established personnel policy that provided for Riverside's Executive Director to receive this fringe benefit. According to state regulations, fringe benefits that are not available to all employees under an established agency policy are unallowable and nonreimbursable under state contracts. Riverside's Executive Director stated that his agency paid the premiums on the policies for his former business associate in return for the former business associate's selling his share of ownership in IAL to Riverside's Executive Director. However, according to state regulations, expenses such as these, which are not directly related to the program purposes of Riverside's state-funded programs, are unallowable and nonreimbursable under state contracts.

3. QUESTIONABLE CASH MANAGEMENT ACTIVITIES CONDUCTED BY RIVERSIDE'S EXECUTIVE DIRECTOR RESULTED IN $232,040 IN UNDOCUMENTED AND/OR INADEQUATELY DOCUMENTED EXPENSES BEING CHARGED BY RIVERSIDE AGAINST ITS STATE CONTRACTS. INCLUDED IN THESE EXPENSES WERE $26,717 IN NON-PROGRAM EXPENSES AND $4,454 IN DUPLICATIVE CHARGES 28

We found that Riverside's Executive Director wrote himself weekly agency checks which averaged $3,200 during our audit period. According to the Executive Director, he cashed these checks and used the funds to purchase items for Riverside's programs. However, our review of the documentation Riverside was maintaining relative to the $423,576 in checks cashed by Riverside's Executive Director revealed numerous concerns. First, there was no documentation to substantiate that $15,898 of these expenses were ever incurred. Additionally, we found that an additional $216,142 of these expenses that were charged by Riverside against its state contracts were inadequately documented of which $26,717 appeared to be non-program-related in that they appeared to be for the personal use of Riverside's Executive Director and his wife. Examples of non-program-related expenses include weekly receipts for food purchased from restaurants, grocery stores, and a delicatessen located in Peabody and Lynnfield, where Riverside's Executive Director and his wife live. These purchases were for food items such as various deli meats, cooked shrimp, lobster rolls, lobster meat, tenderloin steaks,

and a total of $342 in beer and wine that, according to program staff, were never provided to students in Riverside's program. Of particular concern is that we found at least 46 instances totaling $4,454 in which Riverside's Executive Director appeared to resubmit receipts that he used as support to substantiate these weekly expenditures and receive additional duplicative reimbursements from Riverside. According to state regulations, expenses that are duplicative, undocumented, or non-program-related are unallowable and nonreimbursable under Riverside's state contracts.

4. INADEQUATE CONTROLS OVER AGENCY PROGRAM AND ADMINISTRATIVE EXPENSES RESULTING IN INADEQUATELY DOCUMENTED/UNDOCUMENTED EXPENSES TOTALING $264,468, INCLUDING WHAT APPEAR TO BE NON-PROGRAM-RELATED EXPENSES TOTALING $15,138 36

We found that, contrary to the requirements of Generally Accepted Accounting Principles (GAAP), Riverside does not have adequate controls over the authorization and payment of agency program and administrative expenses. As a result, between fiscal year 2002 through March 31, 2004, at least $264,468 in administrative expenses that Riverside charged against its state contracts were inadequately documented, and $15,138 of these expenses did not appear to be related to the social service program purposes of Riverside's state-funded contracts. Examples of non-program-related expenses charged to state contracts included: two weekend season tickets to the Boston Red Sox regular season and post season games for three seasons totaling $12,465, food and gifts for employees totaling $3,783, payments to a dentist totaling $3,791, various donations totaling $1,050, and $5,110 in professional fees incurred by IAL, Riverside's related-party organization. According to state regulations, expenses that are inadequately undocumented or not directly related to the program purposes of Riverside's state-funded programs are unallowable and nonreimbursable to the state. We also found at least four instances in which the items Riverside recorded as being purchased did not correspond to the actual items purchased, according to the vendors we contacted. For example, on February 11, 2004, Riverside paid $145 to 1-800-Flowers.com for what it claimed were decorations for the school. However, the vendor's records indicated that the item purchased was a Valentine's Day flower arrangement for Riverside's Executive Director's wife and his daughter.

5. UNALLOWABLE EMPLOYEE BONUSES AND FRINGE BENEFITS TOTALING $181,901 45

We found that during the period June 1, 2001 through March 31, 2004, Riverside gave its employees bonuses totaling $227,930, of which $127,923 was billed to its state contracts. However, contrary to OSD guidelines, Riverside did not have an established, written employee morale, health, and welfare policy in place at the time it awarded these bonuses. Furthermore, contrary to OSD guidelines, Riverside did not obtain the preapproval of its principal purchasing agency or OSD. Additionally, there was no evidence that Riverside's board was aware of or had approved these bonuses. Without an established, written employee morale, health, and welfare policy in place, the bonus expenses that Riverside billed against its state contracts during our audit period are nonreimbursable according to state regulations. Also, without such controls, there is inadequate assurance that bonuses were distributed in a fair and equitable manner.

In fact, we found that Riverside's Executive Director and his wife received a significantly higher percentage of the total bonuses awarded by Riverside during our audit period (12% and 5%, respectively, as opposed to approximately 1% for non-administrative staff members).

6. UNALLOWABLE PROFIT-SHARING PAYMENTS TO RIVERSIDE'S EXECUTIVE DIRECTOR TOTALING AS MUCH AS $46,917 WERE TEN TIMES THE FACILITY AVERAGE AND EXCEEDED THE FRINGE BENEFIT RATE APPROVED BY DOE 57

During the period covered by our audit, Riverside used $173,440 in state funds to fund what it called a "profit-sharing" plan for members of its staff. Our review of the expenses associated with this plan indicated that the benefits under this plan were provided in a discriminatory manner. Riverside's Executive Director received over 28% of the total profit-sharing distributions issued during our audit period, or more than 10 times what the average staff person received in plan contributions during this period. We also found that the profit-sharing plan distributions Riverside's Executive Director received were unreasonable in that they exceeded the fringe benefit rate approved by DOE for Riverside during the period of our audit. According to state regulations, fringe benefits such as these that are provided in a discriminatory manner or are unreasonable are nonreimbursable expenses under state contracts.

7. QUESTIONABLE COMPENSATION TOTALING $91,035 PROVIDED TO RIVERSIDE'S BOOKKEEPER, THE SPOUSE OF RIVERSIDE'S EXECUTIVE DIRECTOR 64

We found that during the period July 1, 2001 through June 30, 2004, Riverside paid the spouse of its Executive Director a total of $184,453 in compensation to function as Riverside's Bookkeeper, of which $91,035 was charged by Riverside against its state contracts. During our audit, we reviewed this individual's personnel file and spoke with her regarding her job related duties and responsibilities and identified several problems. First, there was nothing in her personnel file that justified why she was hired, how her rate of compensation was established, a job description detailing her duties and responsibilities, or any job performance evaluations. Moreover, this individual's resume indicated that she did not have any formal training or work experience in the area of accounting or bookkeeping. Also, during fiscal years 2003 and 2004, this individual received pay increases totaling almost 20% of her current salary, in addition to a $10,000 bonus during fiscal year 2002 and a $2,160 bonus during fiscal year 2004. However, there were no written evaluations or other documentation on file at Riverside to indicate why she was entitled to receive these significant pay increases. Moreover, during our audit period, Riverside paid accounting consultants and an auditing firm a total of $131,294 to provide various accounting and auditing-related duties, including preparation of all internal adjusting entries to Riverside's General Ledger, preparation of all invoices, and the recordkeeping of all revenue and accounts receivables. According to the Bookkeeper, she worked out of her home, and her primary duties were to make out checks at the direction of the Executive Director and to perform other minor recordkeeping activities. Consequently, we question the reasonableness of providing this level of compensation for the limited services provided by the bookkeeper.

8. HIGHLY QUESTIONABLE AND UNALLOWABLE CREDIT CARD EXPENSES TOTALING AT LEAST $50,472 CHARGED TO STATE CONTRACTS 72

During the period July 1, 2001 through March 31, 2004, Riverside reimbursed its Executive Director and its Bookkeeper $90,325, of which $50,472 was allocated to its state-funded contracts, purportedly for agency expenses charged on their personal credit cards. However, we found that Riverside had not established internal controls relative to the reimbursement of personal credit card expenses. During our audit, we examined the documentation Riverside was maintaining relative to the 529 expenditures totaling $90,325 that were charged on these personal credit cards and noted significant problems. First, none of the 529 expenses were adequately documented. Also, $84,280 of these expenses were questionable, in that they did not appear to be related to the social service program purposes of Riverside's state-funded programs. Examples of these non-program-related expenses we identified include $944 for banquet gifts/sports memorabilia from Jacksonville Golf & Learn of Jacksonville, Florida; $1,070 for two snowboards from Golf and Ski Warehouse in Greenland, New Hampshire; and $356 for a bicycle and a helmet at L.L. Bean in Freeport, Maine. We also identified 113 expenditures totaling $23,458, of which $13,165 was charged to state contracts, in which the voucher documentation used by the Executive Director to request reimbursement for the expense differed from what was indicated on the credit card statement. For example, on March 5, 2002, Riverside paid RB Products of Phoenix, Arizona $460 for what Riverside's voucher indicated was for first aid boxes and various medical supplies for the school. However, the credit card statement indicated that vitamin bars were purchased instead. According to state regulations, expenses that are inadequately documented or not directly related to the program activities of service providers are nonreimbursable under state contracts.

9. UNALLOWABLE AND QUESTIONABLE VEHICLE EXPENSES TOTALING $51,556 80

We found that during the period July 1, 2001 through March 31, 2004, Riverside charged vehicle expenses totaling $117,451 against its state contracts. Included in this amount was $31,619 in expenses relative to a vehicle used by Riverside's Executive Director. However, Riverside's policies and procedures do not provide for the provision of this fringe benefit to this individual. According to state regulations, fringe benefits such as these that are not provided under an established policy of the agency are unallowable and nonreimbursable under state contracts. We also found inadequately documented and questionable expenses totaling $25,510 associated with Riverside's other vehicles, including $7,214 in gasoline charges that appeared to have been incurred by Riverside's related-party organization, IAL, and $5,250 for the purchase of a Jeep Wrangler for which Riverside could not document the business use of this vehicle. According to state regulations, inadequately documented and non-program-related expenses such as these are unallowable costs under Riverside's state contracts.

10. QUESTIONABLE LOANS MADE BY, TO, AND FROM RIVERSIDE'S EXECUTIVE DIRECTOR, AND UNALLOWABLE INTEREST EXPENSES TOTALING $2,325, OF WHICH $1,279 WAS CHARGED TO STATE CONTRACTS 88

During our audit period Riverside's Executive Director used $103,805 Riverside received under its state contracts to give himself three personal loans. However, there were no formal written agreements relative to these loans specifying the terms and conditions of repayment, nor was there any documentation to substantiate that Riverside's board was aware of or had approved of the use of agency funds for these purposes. According to state regulations, expenditures for personal items that are not related to the social service program purposes of the organization are unallowable and nonreimbursable under state contracts. We also found that, during fiscal years 2002 and 2003, Riverside borrowed $190,000 ($40,000 from Riverside's Executive Director and $150,000 from Fleet Bank) to purportedly meet certain cash-flow needs of Riverside. However, we question whether this was a prudent management decision, given that during these two fiscal years Riverside expensed profit-sharing payments and staff bonuses totaling $438,486 that could have been used to pay agency expenses without borrowing any funds. Of particular concern is that Riverside did not have adequate documentation to substantiate that its Executive Director in fact provided the full $40,000 to Riverside.

11. INADEQUATE CONTROLS OVER $118,681 IN CONSULTANT SERVICES 93

Contrary to state and federal regulations, during calendar years 2001 through 2003, Riverside paid 10 consultants a total of $118,681 but did not issue Internal Revenue Services (IRS) Form 1099 to these individuals. In addition, we found that Riverside did not exercise sound contract administration practices relative to these consultant services. For example, for nine of the 10 consultants, there was no documentation that indicated that Riverside utilized a competitive procurement process when procuring these consultant services, and Riverside did not enter into a formal written contract with these consultants. Finally, we found one instance in which Riverside paid an individual as both a consultant and an employee. According to this consultant, he was hired by Riverside as a contractor to do landscaping work, but Riverside's Executive Director, who was his friend, agreed to place him on Riverside's payroll as an employee, so that when his contract was over, he could get laid off and collect unemployment benefits.

12. RIVERSIDE EXPENSED CAPITAL ITEMS TOTALING $73,936 RATHER THAN DEPRECIATING THESE COSTS AS REQUIRED BY STATE REGULATIONS 101

We found that during our audit period, Riverside expensed $73,936 in capital assets against is state contracts, rather than depreciating the cost of these assets over their useful lives as required by state regulations. Consequently, the $73,936 in expenses represent nonreimbursable costs under Riverside's state contracts.

13. INADEQUATE OVERSIGHT BY RIVERSIDE'S BOARD OF DIRECTORS 106

The Board of Directors of a human service provider agency is the primary organizational body that ensures that an 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. However, we found several deficiencies relative to the activities of Riverside's Board of Directors. Specifically, there was no documentation to substantiate that it complied with all of the conditions of its state contracts relative to the approval of compensation for Riverside's Executive Director and the selection of Riverside's audit firm, and there was inadequate documentation to substantiate that the board complied with Riverside's corporate bylaws relative to the review and approval of agency expenses.

14. INADEQUATE ADMINISTRATIVE AND INTERNAL CONTROLS OVER AGENCY OPERATIONS **110**

We found that Riverside had not developed and implemented an adequate system of internal controls over many aspects of its operations. Specifically, we found that Riverside did not properly document its accounting system; did not adequately segregate the duties of its administrative staff; did not maintain all of its records in accordance with state regulations; failed to establish an effective inventory system for its fixed assets, which as of June 30, 2003 totaled $355,468; and did not maintain its accounting records in accordance with GAAP. As a result, the Commonwealth cannot be assured that public funds were properly safeguarded against loss, theft, and misuse and were expended for their intended purposes, or that all of Riverside's transactions were properly authorized, recorded, and reported.

SUBSEQUENT EVENTS **116**

INTRODUCTION

Background

New England Human Services, Inc., DBA Riverside School (Riverside), was founded in 1980 as a for-profit organization for the purposes of operating a school or schools for students with special needs. In May of 1991, Riverside entered into an agreement, effective July 1991, to take over the operations of Institute Day School Inc., which operated a school for special needs students. Also, in July of 1991, Riverside incorporated under the provisions Chapter 180 of the Massachusetts General Laws as a not-for-profit organization for the purposes of operating a school for emotionally disturbed children and providing educational, training, rehabilitative, and residential services for emotionally disturbed, mentally ill, mentally retarded, and disabled individuals.

Riverside is an approved private special education school, and its residential program is licensed by the state's Office of Child Care Services as a 58-bed program servicing a male population between the ages of 7 and 16. Riverside's educational and administrative facilities are located in Lowell. These facilities are leased from an affiliated for-profit organization, Institute Associates of Lowell.

Riverside receives revenue from the Massachusetts Department of Education (DOE) and Department of Social Services (DSS), the state of New Hampshire, and other funding sources, as detailed below:

	Fiscal Year 2002	Fiscal Year 2003	Fiscal Year 2004 (through 3/31/04)
Mass. Govt. Grant	$ 3,000	$ 3,000	$ 7,000
In-Kind Grant/City of Lowell	-	58,005	-
Dept. of Mental Health (DMH)	14,237	490	-
Dept. of Social Services (DSS)	1,602,846	1,680,440	1,291,595
Dept. of Education (DOE)	55,958	157,157	23,790
POS Subcontract	662,730	302,516	398,110
Mass. Local Govt.	1,229,044	1,469,128	709,134
Non-Mass. State Local Govt.	396,813	605,160	677,378
Investment Revenue	(51,029)	2,877	-
Other Revenue	11,765	137	566
Total Revenue	$3,925,364	$4,278,910	$3,107,573

Audit Scope, Objectives, and Methodology

The scope of our audit was to examine various administrative and operational activities of Riverside during the period July 1, 2001 to March 31, 2004. However, in some instances it was necessary for us to extend the period covered by our audit in order to adequately examine certain transactions that were selected for testing during our review.

Our audit was conducted in accordance with applicable generally accepted government auditing standards for performance audits issued by the Comptroller General of the United States, and included such audit procedures and tests as considered necessary to meet these standards.

Our audit procedures consisted of the following:

- A determination of whether Riverside had implemented effective internal controls, including:
  a. Processes for planning, organizing, directing, and controlling program operations;
  b. Policies and procedures to ensure that resource use is consistent with laws and regulations; and
  c. Policies and procedures to ensure that resources are safeguarded and efficiently used.
- An assessment of Riverside's business practices and its compliance with applicable laws, rules, and regulations, as well as the various fiscal and programmatic requirements of its state contracts.

In order to achieve our objectives, we first assessed the internal controls established and implemented by Riverside 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 Riverside's accounting system. We used this assessment in planning and performing our audit tests. We then held discussions with Riverside officials, a member of Riverside's Board of Directors, and officials from the state's Operational Services Division (OSD) and reviewed organization charts and internal policies and procedures, as well as all applicable laws, rules, and regulations. We also examined Riverside's financial statements, budgets, cost reports, invoices, and other pertinent financial records to determine whether expenses incurred under its state contracts were reasonable; allowable; allocable; properly authorized and recorded; and in compliance with applicable laws, rules, and regulations. Finally, we reviewed various documents that were provided

to us by Riverside officials relative to certain activities conducted by Riverside's related-party organization, Institute Associates of Lowell.

During our audit, the scope of our review was limited by Riverside's inability to provide the audit team with certain requested documents in a timely manner. A scope limitation occurs when an auditee places restrictions on the scope of the auditor's work. These restrictions result in a disruption in the timing of the audit work performed, including the inability to apply all of the audit procedures considered necessary by the auditor in the circumstances of the engagement. Such restrictions were encountered by the staff during our audit engagement. The OSA is authorized by its enabling legislation, Chapter 11, Section 12, of the General Laws, to perform audits of entities such as Riverside that contract with the Commonwealth to "determine compliance with the provisions and requirements of such contracts or agreements and the laws of the commonwealth." This statute further mandates that "the state auditor shall have access to such accounts at reasonable times and said department [OSA] may require the production of books, documents, vouchers, and other records relating to any matter within the scope of such audit...." Additionally, regulations promulgated by the OSD, the agency responsible for regulating and overseeing all state contracts awarded to contracted service providers such as Riverside, require service providers to provide all records needed by the OSA, as well as other organizations, to complete an audit. Specifically, 808 Code of Massachusetts (CMR) 1.04 (8) states:

> *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…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, Riverside did not make some of the requested records available to the audit staff. Specifically, Riverside was unable to provide us with the following records:

- Documentation relative to adjusting entries for fiscal years 2002, 2003, and 2004 (through March 31, 2004) made by Riverside's accounting consultant directly to Riverside's general ledgers. Specifically, Riverside could not provide us with documentation to substantiate why these adjustments were made or with evidence that Riverside's management was aware of and had approved these changes.

- As noted throughout the report, during our audit engagement, we noted numerous discrepancies between amounts in Riverside's general ledger and its financial statements.

When agency officials were asked to reconcile these discrepancies, they were unable to provide us with the requested reconciliations.

- Various supporting documentation relative to expenditures made by Riverside during the audit period, as detailed throughout this report.

As of the end of our audit fieldwork, Riverside had not provided any documentation relative to nine of the 71 requests for information we made during our audit engagement. In addition, all of Riverside's financial records were maintained by Riverside's Executive Director at his home in Lynnfield, and were not on-site for our review. In order to conduct our audit testing, we had to request the records we wanted to review from Riverside's Executive Director, who took an average of 12.5 days to produce these records. This significantly delayed our audit work, and in some cases impaired our ability to perform sufficient audit testing in certain areas. Therefore, the audit results and opinions expressed in this report are based solely on the documentation Riverside provided to us during the audit engagement.

Our audit was limited to a review of the activities of Riverside. Although we reviewed various documents relative to certain activities conducted by Riverside's related party, we did not conduct any audit work on site at this entity. Our audit was not made for the purposes of forming an opinion on Riverside's financial statements. We also did not assess the quality and appropriateness of program services provided by Riverside under its state-funded contracts. Rather, our report was intended to report findings and conclusions on the extent of Riverside's compliance with applicable laws, regulations, and contractual agreements, and to identify services, processes, methods, and internal controls that could be made more efficient and effective.

During the conduct of our audit field work, we identified that Riverside commingled the funds that it received from its various funding sources. Consequently, in each Audit Result, we had to calculate the amount of State funds that were involved by taking a ratio of State revenues to total revenues received by the agency during each fiscal year.

AUDIT RESULTS

1. RIVERSIDE ENGAGED IN UNALLOWABLE RELATED-PARTY TRANSACTIONS TOTALING AT LEAST $430,669 AND DID NOT FULLY DISCLOSE THREE RELATED-PARTY TRANSACTIONS

We found that, contrary to state regulations, New England Human Services, Inc., DBA Riverside School (Riverside) used state funds to make payments for the rental of property from Institute Associates of Lowell (IAL), a company owned by Riverside's Executive Director, that exceeded those allowed by state regulations by at least $430,669. Under these lease agreements, in lieu of making a specified dollar amount as a lease payment, Riverside agreed to pay for all the expenses associated with the operation of this property, (commonly known as a "triple net lease") including mortgage principal and interest payments; property taxes; utilities, maintenance, and repair expenses; and at least $432,646 in capital improvements, of which $259,267 was charged by Riverside against its state contracts. Of particular concern is that, according to representatives of Riverside's private accounting firm, beginning in fiscal year 2001, Riverside also provided IAL with an additional $33,000 per year to pay the Executive Director's personal income tax liability that resulted from the profits he made from leasing this space to Riverside.

We also found that contrary to state regulations, Riverside did not adequately disclose in the financial statements it filed with the Commonwealth three other related-party transactions during our audit period. By not disclosing these transactions, Riverside did not provide its state and other funding agencies, as well as other users of this financial information, with all the information necessary to assess Riverside's operations. The specific problems we identified in these areas are detailed below:

a. Highly Questionable Related-Party Transactions Totaling $430,669

The state's Operational Services Division (OSD), the agency responsible for regulating and overseeing the activities of contracted service providers such as Riverside, has promulgated regulations relative to related-party transactions. OSD defines a related party in 808 Code of Massachusetts Regulations (CMR) 1.02 as:

> *Any person or organization satisfying the criteria for a Related-party published by the Financial Accounting Standards Board in Statement of Financial Accounting Standards No. 57 (FASB 57).*

FASB 57, in turn, defines a related party as follows:

> *Affiliate of the enterprise; entities for which investments are accounted for by the equity method by the enterprise; trust for the benefit of employees, such as pension and profit sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests. Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.*

During our audit, we found that Riverside was leasing property for use in its programs from a related-party organization, Institute Associates of Lowell (IAL), which is owned by Riverside's Executive Director. These transactions included the lease of two facilities located at 258 and 475 Varnum Avenue in Lowell (lease effective June 23, 1997) and one facility located at 34 Berry Road in Lowell (lease effective June 23, 1998). Under the terms and conditions of these leases, IAL was going to provide "the entire square feet" contained in the three aforementioned locations. These leases were for five-year periods and had an option to be extended for an additional five years at "market value." In addition, a modular building was erected by IAL in August 1999 at the 34 Berry Road location, which was subsequently leased by Riverside from IAL. However, IAL and Riverside did not execute a formal written lease for this property.

As a consequence of its relationship with IAL, Riverside must comply with regulations promulgated by OSD regarding related-party transactions. Specifically, 808 CMR 1.05(8) defines the following costs as being unreasonable and therefore nonreimbursable under state contracts:

> *Related Party Transaction Costs. Costs which are associated with a related party transaction are reimbursable only to the extent that the costs do not exceed the lower of either the market price or the related party's actual cost.*

Regarding costs, the leases entered into between Riverside and IAL did not specify a lease payment amount, but rather defined the lease amount Riverside was to pay as "all of the costs of the premises, including, but not limited to: mortgage payments, insurance, real estate taxes, heating and air conditioning costs, landscaping and snow removal, all utility costs, etc."

During the period of our audit, Riverside paid a total of $784,760 to IAL[1] for the use of these properties, as indicated in the table below:

Summary of IAL Property Expenses Paid by Riverside

Fiscal Year	IAL's Mortgage/Lease Payments	Property Taxes	Utilities	Total Rent
2002	$204,152	$28,164	$46,526	$278,842
2003	209,152	30,526	42,883	282,561
2004 (through March 31,2004)	161,564	25,088	36,705	223,357
Total	$574,868	$83,778	$126,114	$784,760

In addition to paying all the occupancy expenses noted in the table above, between March 1994 and March 2004, Riverside also paid for capital/leasehold improvements, such as new windows and carpeting totaling $432,646 for the properties it was leasing from IAL, and charged $259,267 of these expenses against its state contracts. The table below summarizes the capital improvements made by Riverside to IAL's properties during the period under review as well as the funds used to pay for these expenses.

Fiscal Year/ Period	Leasehold Improvements Varnum Ave.	Leasehold Improvements Berry Road	Total Improvements	Total Charged to MA State Contracts
March 1994 (through 6/30/02)	$117,634	$308,599	$426,233	$255,740
2003	0	0	0	0
2004 (through March 31,2004)	6,413	0	6,413	3,527
Total	$124,047	$308,599	$432,646	$259,267

Given that these lease agreements between Riverside and IAL represented related-party transactions, during our audit we wanted to assess the reasonableness of these lease payments. In order to do this, we first determined what the fair market rental cost (FMR) would be for the space Riverside was renting from IAL. We obtained from the City of Lowell's Assessor's Office an assessment of each property and found that the properties

[1] These payments were not made directly to IAL, but to various financial institutions and businesses by Riverside on IAL's behalf. For example, each month Riverside would issue a check to the lending institution for IAL's mortgage on these properties.

located at Varnum Avenue and Berry Road were classified by the City of Lowell as residential properties, whereas the modular building at 34 Berry Road was assessed as commercial property. We then used the Federal Register[2] to determine the FMR for IAL's residential properties for each fiscal year of our audit period. We then obtained commercial leasing information from the City of Lowell's Division of Planning and Development's Site Finder database[3]. Based on our analysis, we determined that the FMR for the space being leased by IAL to Riverside would be $473,589 during the period July 1, 2001(fiscal year 2002) through March 31, 2004, as indicated in the table below.

Properties	Bedrooms/Square Footage	Zoning Use	FMR			Totals
			Fiscal Year 2002	Fiscal Year 2003	Fiscal Year 2004	
475 Varnum Ave.	4	Residential	$14,376	$16,956	$13,419	$44,751
258 Varnum Ave.	5	Residential	16,536	19,500	15,435	51,471
34 Berry Road	6	Residential	18,696	22,044	17,451	58,191
Modular 34 Berry Road	9,672 sq. ft.	Commercial	116,064	116,064	87,048	319,176
Totals			$165,672	$174,564	$133,353	$473,589

We then compared the payments made by Riverside to IAL relative to the use of this property to what we determined to be FMR and noted that the payments made by Riverside exceeded those allowed by state regulations by at least $743,817, as indicated in the table below:

[2] The Federal Register is maintained by the U.S. Department of Housing and Urban Development (HUD). HUD annually sets fair market rents, which are used for assessing public housing units. The fair market rents, as defined by 24 Code of Federal Regulations (CFR) Ch. IX, is the "rent, including the cost of utilities (except telephone), as established by HUD for units of varying sizes (by number of bedrooms), that must be paid in the housing market area to rent privately owned, existing, decent, safe and sanitary rental housing of modest (non-luxury) nature with suitable amenities."

[3] The "Site Finder" is a resource provided by the City of Lowell, Division of Planning and Development, which continuously updates a database of available commercial and industrial properties in Lowell and the rental costs of these properties. It is available for the public in order to provide planning information to new and existing Lowell businesses and to other interested parties.

Fiscal Year	Total Payments made by Riverside	FMR	Amount paid over FMR
March 1994 to 6/30/02	$705,075*	$165,672	$539,403
2003	282,561	174,564	107,997
2004 (Through March 31, 2004)	229,770*	133,353	96,417
Totals	$1,217,406	$473,589	$743,817

* These amounts also include the amounts for capital/leasehold improvements paid for by Riverside at these properties. They are $426,233 and $6,413, respectively.

Of this $743,817 in unallowable expenses, Riverside charged $430,669 against its state contracts, as indicated in the table below:

Summary of Unallowable Related-Party Expenses Charged to the Commonwealth

Fiscal Year	Total Payments over FMR	Allocated to MA State Gov.	Allocated to MA Cities and Towns	Allocated to State of NH	Other*
March 1994 to 6/30/02	$539,403	$323,642	$167,215	$53,940	($5,394)
2003	107,997	53,998	38,879	15,120	0
2004 (through March 31,2004)	96,417	53,029	22,176	21,212	0
Total	$743,817	$430,669	$228,270	$90,272	($5,394)

*These funds were taken out of Riverside's surplus revenues and applied as offsets to these expenses.

Of particular concern is that, beginning July 1, 2000, Riverside agreed to pay IAL an additional $33,000 in rental payments per year. According to representatives from Riverside's private accounting firm, this $33,000, which is included in our total rent figures detailed above, was:

> *...to keep the landlord [IAL/Riverside's Executive Director] in a tax neutral position. The capitalized lease payments on the Berry Road mortgage payments far exceed the depreciation expense for these assets. This generated taxable income for the entity without any cash to pay the taxes. The additional rent is to provide the cash for the taxes so that the landlord [Riverside's Executive Director] would not have an after tax negative cash flow.*

Regarding these matters, Riverside's Executive Director stated that he was unaware that the rent that Riverside was paying to lease these properties was above fair market value and therefore unallowable in accordance with state regulations. However, clearly the Executive

Director used state funds inappropriately, which resulted in his personal gain of at least $430,669 during the period covered by our audit.

b. Undisclosed Related-Party Transactions and Relationships

In addition to promulgating regulations, OSD has published various documents that provide guidance to human service organizations such as Riverside and their private accounting firms on how to assess an entity's compliance with applicable laws and regulations. Regarding the disclosure of related-party relationships, the Uniform Financial Statement and Independent Auditor's Report (UFR) Auditor's Compliance Supplement under 808 CMR 1.00 published by OSD, which was in effect during our audit period, states, part:

> *All material related-party transactions that are not associated with programs purchased by the Commonwealth or that could affect the provider's financial statements and all instances of common ownership or management control relationships for which 808 CMR 1.02 and the AICPA Statement of Financial Accounting Standards No. 57 (SFAS No. 57) require disclosure, even though there are no transactions, should be disclosed in the UFR notes to the financial statements....*

OSD has also established penalties for organizations that do not comply with its regulations relative to the disclosure of related-party transactions in 808 CMR 1.04 (11)(c), which states, in part:

> *If, after a hearing, DPS [now OSD] finds a violation of 808 CMR 1.04(4), 1.04(5) or 1.05, DPS may order that the contract(s) directly affected by such violation be terminated or may assess a civil penalty of not more that $2,000 or 10% of the Contractor's annual Maximum Obligation under such contract(s), whichever is greater. If DPS determines after a hearing that a Contractor has committed repeated willful violations of 808 CMR 1.04(4), 1.04(5) or 1.05, DPS may debar the Contractor for a period not to exceed five years.*

During our audit, we reviewed the UFRs submitted by Riverside to OSD for fiscal years 2002 through 2003 and found that the following three related-party relationships were not adequately disclosed by Riverside, contrary to OSD guidelines:

- Information regarding Riverside's relationship with IAL was not fully disclosed in Riverside's UFRs for fiscal years 2002 and 2003. Specifically, these financial statements do not disclose that Riverside's Executive Director, as of March 2001, became the sole owner of IAL. Further, these statements do not disclose that IAL rents all of its properties to Riverside and that, during our audit period, Riverside paid all of IAL's liabilities pertaining to these properties.

- The related-party transactions noted in Audit Result No. 2, whereby Riverside was paying the premiums on insurance policies purchased by a former business associate of Riverside's Executive Director, were not disclosed in these financial statements.

- During fiscal years 2002 and 2003, a member of Riverside's Board of Directors was paid $1,207 and $6,260, respectively, for performing a variety of maintenance services, including installing a railing and stair system and performing various renovations to a bathroom, kitchen floor, and radiators in Riverside's faculties. However, these related-party transactions were not disclosed in Riverside's UFRs during these fiscal years. It should be noted that during the period December 31, 2003 through June 30, 2004, this board member was employed as a full-time employee of Riverside and was paid a total of $26,375.

Riverside's Executive Director did not comment on why these transactions and relationships were not disclosed in Riverside's financial statements. Because Riverside did not disclose this information in its UFRs, the Commonwealth and other users of these reports were not provided with all the required information necessary to properly monitor and evaluate Riverside's fiscal, operational, and programmatic activities during these fiscal years.

Recommendation

In order to address our concerns relative to this matter, we recommend the following:

- Riverside's principal state purchasing agency, DSS, should recover from Riverside and its Executive Director the $430,669 in unallowable related-party expenses it charged against its state contracts during the period covered by our audit. Further, DSS, in conjunction with OSD, should conduct its own review of the lease expenses charged by Riverside against its state contracts for payments it made on behalf of IAL for fiscal years 1998 through 2002. Based on this review, DSS should recover from Riverside and its Executive Director any additional funds it deems appropriate.

- Riverside should amend the notes to its financial statements in its fiscal years 2002 and 2003 UFRs to properly disclose all related-party transactions and relationships. In the future, Riverside should take measures to ensure that it fully discloses all related-party relationships and transactions in its UFRs. Regarding Riverside's failure to disclose the related-party transactions noted in our report, OSD, in conjunction with DSS, should determine whether the Commonwealth should subject Riverside to any penalties or debarment as authorized under 808 CMR 1.04 (11)(c).

Auditee's Response

In response to this audit result, a law firm representing Riverside stated, in part:

> *Riverside freely acknowledges, and at no time attempted to conceal, the fact that Riverside rented property from a company owned by Riverside's Executive Director, Institute Associates of Lowell, Inc. ("IAL"), and that Riverside used state funds to make payments for the rental of the property. Riverside points out, however, that there is nothing inherently wrong or legally impermissible about this type of related-party transaction. Indeed, the OSD regulations expressly* permit *related party transactions, subject only to reasonable, fair market value limitations.* See, e.g., *808 CMR 1.05(8). Therefore, the issue here is not whether the rental of space from IAL was "questionable" or "unallowable." The question is: what is the appropriate fair market value against which the rental payments are measured? Riverside respectfully believes that the Auditor's methodology in calculating the fair market rental ("FMR") of IAL's property placed too great an emphasis on governmental data, which is averaged and skewed toward lower-income housing, and did not take into account actual market prices for this property. As a result, the FMR against which the rental payments were measured was unrealistically low, and results in an unfair and inaccurate conclusion.*
>
> *To permit a more accurate calculation of the property's actual market value, Riverside has produced herewith copies of a rental appraisal of the subject property, as well as a rental agreement that shows the actual market rental value of the IAL property to an unrelated third party. . . .As one can see from the appraisal, the rental value of this property is $348,000 per year, which is significantly greater than the total rent actually charged by IAL ($278,842 in 2002; $282,561 in 2003). Moreover, the subject property is now being rented to the new operator of the school - an independent third party - for $315,000.00 per year triple net, an amount greatly in excess of the amount charged to the "related party.". . .The fact that an independent third party is presently paying much more to IAL than IAL was paid in a "related-party transaction" indicates that the amount paid to IAL under the previous management was well within the regulatory parameters of a related-party transaction, in that the "[c]osts which are associated with [this] related party transaction are reimbursable . . . to the extent that the costs do not exceed the lower of either the market price or the related party's actual cost." See, 808 CMR 1.05(8).*
>
> *In addition, shortly after NFI acquired the assets of Riverside in 2004, NFI began looking for additional space in which to relocate another program it was operating. During the search for space, NFI inquired of a property that was mid-way between the buildings it rented from IAL at 258 and 475 Varnum Avenue in Lowell. The landlord, the Commonwealth of Massachusetts, wanted to charge $15/s.f., triple net, for basement space, and NFI would still have to build to suit. By comparison, NFI was paying $12-$13/s.f. for the IAL property (fully built), and (NEHS) had only paid $10-$11/s.f., including all operational costs. Plainly, based on actual market value, Riverside had paid an extremely reasonable, below-market value rent for its space.*
>
> *The draft report also notes that. . .Riverside "paid for capital/leasehold improvements . . . totaling $432,646 to the properties it was leasing from IAL, and charged $259,267 of these expenses to its state contracts." Riverside has several concerns regarding these figures.*

a. It is unclear why the report analyzes "Improvements" that pre-date the audit period by as much as 7 years. To factor costs incurred outside the audit period against expenses paid during the audit period severely skews and misrepresents Riverside's actual costs during the audit period.

b. These rent expenses represent, in the most part, the debt service of the related party, which is a normal payment in a typical triple net lease.

c. It is quite common and a generally accepted practice for a lessee to pay for improvements to rental property to suit the lessee's needs. Such payments are either paid for directly, or reflected in the rental price ...

e. There is no indication whether the auditors measured the propriety of expenses incurred prior to the audit period against the OSD standards that were in effect at the time such expenses were incurred...

Consequently, a significant portion of the alleged "related-party expenses" [$323,642] of the [$430,669] may not be unallowable, leaving the relatively immaterial amount of [$107,027] during the audit period. Similarly, the same holds true for the leasehold improvements ($426,233 out of $432,646), leaving just $6,413.

For the foregoing reasons, Riverside believes that the rental valuations utilized in the draft audit report do not accurately reflect the fair market value of the property.

In addition, the report objects to Riverside paying an additional $33,000 per year to pay the Executive Director's personal income tax liability that resulted from the profits he made from leasing the space to Riverside. Riverside believes that this entry comports with the spirit and intent of the regulations. Because IAL is a sub-chapter S corporation, the tax liability on any income generated by IAL is passed directly through to its principal, the Executive Director. Consequently, IAL provided the Executive Director with sufficient compensation to ensure that he had a neutral tax position. This was, in effect, one of IAL's "actual costs" of operating. In that sense, it was charged to Riverside as a cost of the property, pursuant to 808 CMR 1.05(8). Indeed, this approach was perfectly consistent with Riverside's payment of all "costs" associated with the property.

As the foregoing demonstrates, Riverside's rental arrangement with IAL actually resulted in <u>lower</u> costs to Riverside as compared to both the fair market independent appraisal of the subject property and the actual rental paid by an independent third party. Rather than being categorized as "highly questionable," Riverside's efforts should be lauded as they saved the Commonwealth significant money.

Riverside now recognizes that it needs to amend the notes in its financial statements in its FY '02 and [FY] '03 UFR's to more adequately disclose all related-party transactions and relationships. As the auditors noted, the Executive Director had no explanation for the omissions because it was simply an unintentional oversight.

Nonetheless, what is or is not stated in the notes in Riverside's UFR does not detract from the fact that the moneys were properly used and allocated. . . .As discussed in greater detail above, Riverside had a very common triple net lease with IAL, under which Riverside paid all of IAL's operating costs associated with the property. The extent of disclosure does not change the fact that the payments were proper, were actually below fair market value, and in the best interest of the students and furtherance of Riverside's mission. . . .

The payments Riverside made on the premiums on insurance policies purchased by a former business associate of Riverside's Executive Director, were part of a fair and reasonable buy-out of the former business associate's interest. Once again, the extent of disclosure does not affect the propriety of the arrangement. What is important is that it in no way detracted from Riverside's mission, and did not result in an unallowable use of state funds.

Regarding payments for services rendered by a member of Riverside's Board of Directors, these were reasonable and necessary maintenance services which should not be questioned unless they are or can be demonstrated to be excessive or unnecessary. Indeed, failure to [sic] provide for such services would have been irresponsible, and could expose Riverside and the Commonwealth to liability if students, families or visitors were injured because of a lack of repairs or inadequate parking. Moreover, by definition the amounts expended on these services for FY '02 and FY '03 ($1,207 and $6,260, respectively) are not "material," and do not need to be disclosed on the UFR. Similarly, payment of $26,375 for the full-time services of a maintenance employee is not "material," and did not need to be disclosed...

Auditor's Reply

Our report does not state or even imply that related-party transactions are inherently wrong or illegal. Rather, our report correctly points out that when related-party transactions occur, OSD regulations determine the amount of state funds that can be paid to a related party in order to ensure that these funds are protected from abuse and misuse. Specifically, payments to a related party are only reimbursable to the extent they do not exceed the lower of either the fair market value or the related party's actual costs. As stated in our report, based on our analysis, the state portion of the payments Riverside paid to IAL, a related party, to rent the properties in question exceeded the fair market value by as much as $430,669 during the period covered by our review.

It is important to note that Riverside and IAL never attempted to formally establish a fixed fair market monthly rental cost. Rather, as stated in our report, in addition to paying for all the improvements to the properties in question, Riverside agreed to pay "all of the costs of the premises, including, but not limited to: mortgage payments, insurance, real estate taxes, heating and air conditioning costs, landscaping and snow removal, all utility costs, etc." Because IAL did not have a checking account, Riverside paid all expenses associated with this property directly to IAL's payees. For example, Riverside paid IAL's mortgage payments, including interest and principal, directly to the bank that held the mortgage on the properties in question, rather than issuing a check to IAL. Given that Riverside was making these payments directly to payees, we could have reasonably questioned all costs that were included in these payments, which are unallowable in accordance with OSD regulations (e.g., principal payments, property taxes, and the annual payments of $33,000 to Riverside's Executive Director to pay for his personal income

taxes), and totaled hundreds of thousands of dollars. In addition, Riverside did not even have a lease for the space it was renting from IAL located in the modular building located at 34 Berry Road. Therefore, we could reasonably argue that any expenses paid by Riverside relative to this property were nonreimbursable, since Riverside had not entered into any formal written agreement that required it to pay for these expenses. However, we chose to take a more conservative approach to our analysis and accept the notion that all of the expenses paid by Riverside relative to these properties did in fact represent the rent for these properties.

In its response, Riverside refers to what it calls a "rental appraisal" of the properties in question that it provided to us for our review. Riverside contends that this rental appraisal indicates that the rental values of the properties rented by IAL to Riverside were in fact higher than the amounts Riverside was actually paying. However, it should first be noted that the appraisal referenced by Riverside in its response was an appraisal conducted for the purposes of determining a sales price for these properties for its owner (Riverside's Executive Director), and was not done for the express purpose of determining a fair market rent for the property. In fact, only two of the 87 pages in this appraisal report discuss potential rental income for this property. In terms of the methodology used by the appraiser to value this property, the appraisal report specifically discloses the fact that the appraiser could not find comparable rental space to the properties being rented by Riverside from IAL for comparisons by stating, in part:

> *In appraising real estate of the subject's type, the following methods may be used:*
>
> - *The Cost Approach, which adds the estimated value of the underlying land and the depreciated improvement to derive a value indication.*
> - *The Sales Comparison Approach, which compares the subject to sales of similar properties to derive a value indication.*
> - *The Income Approach, which has two potential methodologies; Direct Capitalization and Discounted Cash Flow Analysis. The first methodology uses capitalization techniques to convert anticipated benefit into an indication of value, while the second applies a discount rate to a set of projected income streams and a reversion to determine value.*
> - *The Development Procedure, which values underdeveloped acreage by discounting the cost of development and the probable proceeds form the sale of developed sites. This method incorporates components from each of the other three approaches.*
>
> *In appraising the subject, I used the Cost Sales Comparison Approach, which are explained in the valuation sections of this report. I researched the central New England area for leases of similar facilities in order to develop the Income Approach. However,*

> *there was insufficient data available to reliably develop that approach, since most facilities are owner-occupied. As a result, the Income Approach is not utilized. . . .*
>
> *As I indicated earlier in the report, there was insufficient evidence to develop an Income Approach. A survey of the Massachusetts, New Hampshire and Maine market area failed to uncover any similar properties that were leased.*
>
> *It is also possible to estimate the market rent based upon the market values. This would be the inverse to capitalizing the net income to derive the value via an Income Approach. Assuming a CAP Rate of 12%, which is slightly higher than real estate alone, since yours is essentially a Going Concern business, the calculation would be as follows:*
>
> *Estimated Value: $2,900,000 x .12 = $348,000 annual rent*
>
> *Again, this is the best evidence I can give you as far as the possible rent of the property, which would be in the $9.00 to $12.00 per SF range on a net basis.*

As noted in the appraisal report, the appraiser was not able to use the Income Approach to value the sales price of this property because there were not enough similar properties being leased to make this comparison. Rather, this report states that the appraiser assumed a CAP rate of 12% and multiplied this CAP rate by his appraised value of the property. A CAP rate, which is a ratio used by appraisers to estimate the value of income-producing properties, is calculated by dividing the net operating income (in our case net rents) of the property by the sales price or value of the property. For example, if a property has annual net operating income of $155,000 and is being sold for $1,200,000, its CAP rate is 12.9% ($155,000/$1,200,000 x 100%). In this appraisal report, the appraiser states that he could not "uncover any similar properties that were leased" in order to make a comparison of market rents. As a result of this condition, the appraiser uses an assumed CAP rate in his calculation of rental income the property could potentially generate. Although we do not question that this calculation may provide an estimate of potential rental income from this property, we clearly believe that our use of HUD's fair market rental information to be an equally accurate and appropriate measure of fair market rental rates for the properties in question. In particular, HUD's fair market rental rates are based on a number of factors relative to the local housing market as a whole, including a survey of market rents, and are not based on assumptions and estimates. For the commercial property that Riverside was renting from IAL, as stated in our report, we used information provided by the City of Lowell that indicated that similar commercial space within Lowell was being rented at between $9 and $12 per square foot. For our calculation, we conservatively used the $12 figure, which is also at the high end of the fair market footage rate suggested by the appraiser ($9-$12 per square foot)

in his report. Consequently, it appears to be an accurate and appropriate figure to use in our calculations.

In its response, Riverside contends that its lease with NFI for these properties represents a good estimate of fair market value since NFI allegedly represents an independent third party. However, it should be noted that during the conduct of our audit fieldwork, it came to our attention that NFI was negotiating with Riverside's Executive Director to assume the operation of the school and the administration of the state contracts that funded its operations. As a result of these negotiations, Riverside's Executive Director was hired by NFI as a consultant. Specifically, regarding this matter, the Subsequent Events section of this report states, in part:

> *On July 1, 2004, Riverside's Executive Director became a part-time consultant to NFI per a consulting agreement dated April 8, 2004 (three weeks before Riverside was sold to NFI). This consultant agreement indicates that he will receive $125/hour for a minimum of 1,000 hours per year or $125,000 per year for the next five years, with the option to renew, for a grand total of $625,000.*

Because Riverside's Executive Director was negotiating with NFI for the transfer of the operation of the school and was in fact hired as a consultant by NFI prior to turning over the operation of the school to NFI, we question whether the rental transaction between NFI and Riverside represents a true independent third party transaction. Further, since NFI was assuming the operation of the school, it needed to continue to rent the space that was being used by Riverside to house this program, because the relocation of all the students in this program to another facility on short notice may not have been possible. Consequently, NFI had very little negotiating ability in terms of establishing the rental costs for these properties. Also, in its response, Riverside states that NFI tried to find additional property in the same area as the properties in question to house some of its programs, and found that the rental costs being charged for this space were higher than the amount Riverside was paying to IAL. However, as Riverside did not give us any documentation to substantiate this claim, we are unable to comment on this assertion.

Our report correctly and accurately includes the cost of the capital improvements made to the properties in question that were paid for by Riverside with state funds in our calculation of non-reimbursable related-party costs. Because these payments were considered part of the rent Riverside was paying for this space, it was not only appropriate but also necessary for us to include these expenses in our calculation. Also, according to the terms and conditions of its state

contracts, contracted service providers such as Riverside are required to maintain their records for a period of seven years. During the conduct of our audit field work, we determined that the amounts Riverside was paying to its related party, IAL, to lease the space in question exceeded that which was allowed by state regulations. According to OSD officials, this prohibition on the amounts state contracted service providers can pay to their related parties has been in effect for approximately 10 years. Consequently, it was necessary for us to determine the extent to which these related party expenses were excessive over the entire period of time Riverside was required to maintain its records relative to these transactions. Contrary to what Riverside contends in its response, the audit testing we conducted that covered this seven-year period in no way skewed or misrepresented Riverside's costs. Rather, this testing provided a more comprehensive and accurate accounting of the nonreimbursable related-party expenses paid by Riverside to its related party through these lease arrangements. Moreover, it should be noted that many of these capital improvements were paid for without the benefit of an actual lease agreement that required payments from Riverside to IAL for such improvements. In fact, there was no lease agreement for the property leased by Riverside from IAL located at 34 Berry Road, where most of these improvements ($308,599 of the $432,646, or 71%) were performed, thereby raising a question as to propriety of the entire amount of these expenses. It is important to note that in the agreement between Riverside's Executive Director and NFI, Riverside's Executive Director agreed to repay Riverside $300,000 for improvements made to the properties in question, indicating that even NFI had issues with Riverside paying for these expenses.

As stated in our report, the related-party transactions noted in Audit Result No. 2, whereby Riverside was paying the premiums on insurance policies purchased by a former business associate of Riverside's Executive Director, were not disclosed in Riverside's financial statements. These were significant related-party transactions and should have been disclosed in accordance with OSD regulations in these statements. Further, we do not agree with Riverside's assertion that the insurance premiums it paid on behalf of the agency's former business partner did not represent a misuse of state funds, as further discussed in the Auditor's Reply to Audit Result No. 2.

We also do not agree with Riverside's assertion that providing Riverside's Executive Director with $33,000 per year to cover personal income tax liability "comports with the spirit and intent of the regulations." To the contrary, an individual's personal tax liability has nothing to do with

the provision of program services, is clearly non-programmatic in nature, and is therefore a nonreimbursable expense under state contracts. Also, contrary to what Riverside states in its response, according to the agency's records, Riverside's Executive Director received $33,000 in annual payments from Riverside using state funds and not IAL funds. Although Riverside contends that these funds were provided to its Executive Director to put him in a "neutral tax position," it did not provide us with any documentation to substantiate this assertion. Moreover, the mere fact that Riverside agreed to pay its Executive Director an additional $33,000 per year to pay for the additional income taxes he incurred as a result of this business transaction seems to indicate that the Executive Director was making a substantial profit on the leasing of these properties to Riverside, which is not allowable since OSD regulations state that these related-party transactions are only allowable to the extent that they are conducted at the lower of the related party's actual costs (which would preclude a profit) or fair market value. In our opinion, the annual payments of $33,000 to Riverside's Executive Director would have been better used to provide needed services to Riverside's clients.

As stated in our report, during our audit, we reviewed the UFRs submitted by Riverside to OSD for fiscal years 2002 and 2003 and found that three related-party relationships were not adequately disclosed by Riverside, contrary to OSD guidelines. In its response, Riverside explains the nature of these related-party transactions and contends that they were all proper. In addition, Riverside contends that these expenses were not "material and do not need to be disclosed in the UFR." However, Riverside does not disclose the methodology it used to determine which transactions are "material" and which are not. Further, this latter assertion clearly demonstrates Riverside's lack of understanding of the regulatory requirements in this area. Specifically, as noted in our report, Riverside is required to disclose all related-party transactions in excess of $100 per year prior to entering into the related party transaction, not just those it considers to be "material," as detailed in 808 CMR 1.05(4):

> *(4) Related Party Transactions. Notice of all Related Party transactions (including the relationship of the Related Party and a description of the nature and amount of the transaction) shall be made in writing to DPS and the Department(s) prior to their execution. In the case of an M.G.L. c. 71B Approved Private School Program, notification shall be given to DPS and DOE. If disclosure was made through a response to a Request for Response pursuant to 801 CMR 21.00, within an executed contract, or through other formal means, such disclosure will satisfy the requirements of 808 CMR 1.04(4). Prior written disclosure shall not be required where the total value of transactions with a Related Party is less than $100 within the year, and shall not be required where the*

transaction is a gift to the Contractor from an official, administrator or manager of the Contractor.

Since the transactions did not meet the exemption requirements detailed in the aforementioned regulations (e.g., less than $100 within one year), they were therefore "material" in terms of these regulations and should have been disclosed as such by Riverside prior to the related-party transaction being conducted, as well as in the notes to its financial statements. Because Riverside did not disclose this information in its UFRs, the Commonwealth and other users of these reports were not provided with all of the required information necessary to properly monitor and evaluate Riverside's fiscal, operational, and programmatic activities during these fiscal years.

2. RIVERSIDE'S EXECUTIVE DIRECTOR USED $348,623 IN STATE FUNDS TO PURCHASE LIFE INSURANCE POLICIES FOR HIMSELF AND A FORMER BUSINESS ASSOCIATE, WHO WAS NOT AN EMPLOYEE OF RIVERSIDE

During fiscal years 2002 through 2004 (through March 31, 2004), Riverside used $348,623 in state funds to purchase life insurance policies for Riverside's Executive Director and a former business associate of the Executive Director, who was not an employee of Riverside. However, Riverside did not have an established personnel policy that allowed the Executive Director to receive this fringe benefit. According to state regulations, fringe benefits such as this that are not available to all employees under an established policy of the agency are unallowable and nonreimbursable under state contracts. Riverside's Executive Director stated that his agency paid the premiums on the policies for his former business associate in return for the former business associate's selling his share of ownership in a related-party organization, IAL, to Riverside's Executive Director. However, according to state regulations, expenses such as these, which are not directly related to the program purposes of Riverside's state-funded programs, are also unallowable and nonreimbursable under state contracts.

The 808 CMR 1.05, promulgated by OSD, identifies the following as nonreimbursable costs under state contracts:

(9) Certain Fringe Benefits.

(a) Fringe benefits determined to be excessive in light of salary levels and benefits of other comparable Contractors and fringe benefits to the extent that they are not available to all employees under an established policy of the Contractor...

(12) Non-Program Expenses. Expenses of the Contractor which are not directly related to the social service Program purposes of the Contractor.

During our audit, we found that Riverside was using state funds to purchase life insurance policies for Riverside's Executive Director and a former business associate of Riverside's Executive Director (a co-owner of IAL), who was not an employee of Riverside. When asked to provide us with information about these insurance policies, Riverside's Executive Director stated that he did not have any. Consequently, during our audit, we contacted a company representative from Winchester Benefit Group (WBG), which was managing these policies on behalf of Riverside's Executive Director and his former business associate. The payment history and policy information we were able to obtain from this representative relative to these insurance policies is summarized below:

Summary of Insurance Information

Riverside's Executive Director

Fiscal Period	Policy Number	Status	Policy Face Amount	Policy Cash Value	Cash Out	Payments
Prior to audit period	7390165	In force	$1,312,049			$65,058
2002	7390165	Replaced	$1,312,049			4,103
2002	7390169	In force	$1,050,000			39,644
2003	7390169	Replaced	$1,050,000		$29,889*	0
2004	546018234N	Current	$1,000,000	$27,440		30,000
Total				$27,440	$29,889	$138,805

* Although the records provided to the audit team did not indicate a cash value amount for this policy, the representative from WBG with whom we spoke indicated that this amount was paid to the Riverside's Executive Director when this policy was replaced.

As noted in the table above, during the past several years, the policies that Riverside was funding for its Executive Director changed. However, the policy that was in effect during the conduct of our audit fieldwork was what is referred to as a "flexible premium" life insurance policy. The insured individual under this policy is Riverside's Executive Director, and the owner is the [Name of Riverside's Executive Director] Irrevocable Insurance Trust. The representative from WBG with whom we spoke indicated that for this type of insurance, money is invested in the stock market, and that therefore variances in the policy's cash value can occur. Specifically, the policy states, in part:

The amount and/or duration of the death benefit and other values provided by this policy are based on the investment experience of the separate accounts(s). Values are

> *variable, may increase or decrease, and are not guaranteed as to fixed dollar amount. Depending on the performance of the investment options, you could lose your entire investment; as a result, there could be no death benefit unless additional premium payments are made to keep the policy in force.*

The death benefit is guaranteed and is payable to an Irrevocable Insurance Trust in the name of Riverside's Executive Director, whose owner is the wife of Riverside's Executive Director.

The insurance information relative to the policies and premiums paid by Riverside on behalf of the former business associate of Riverside's Executive Director follows:

Insurance Premiums

Made by Riverside on Behalf of a Former

Business Associate of Its Executive Director

Fiscal Period	Policy Number	Status	Face Amount*	Payments
Prior to Audit period	7351417	In force	$400,000	$161,000
Prior to Audit period	4764331/7387926	In force	$250,000	33,185
Prior to Audit period	541395	In force	$700,000	181,000
2002	7351417	In force	$150,000	6,606
2002	4764331/7387926	In force	$250,000	11,195
2002	541395	In force	$700,000	7,500
2003	7351417	In force	$150,000	4,833
2003	4764331/7387926	In force	$250,000	8,932
2003	541395	In force	$700,000	11,500
2004	7351417	In force	$150,000	11,195
2004	4764331/7387926	In force	$250,000	6,606
2004	541395	In force	$700,000	7,500
Total				$451,052

* The face value of the fiscal year 2004 policies that were in force during our audit period totaled $1,100,000.

Based on our review of Riverside's records, we determined that there is no agency policy or formal written employment contract between Riverside and its Executive Director that provided for the provision of these benefits to this individual. Therefore, the $138,805 that Riverside charged against its state contracts to provide this fringe benefit to its Executive Director represented nonreimbursable expenses in accordance with 808 CMR 1.05(9)(a).

In addition, we found that the payments made by Riverside on behalf of its Executive Director's former business associate were recorded by Riverside in its financial statements as a receivable from IAL. However, according to agency records, there was no formal written agreement between Riverside and IAL that ever required repayment of these funds. As of the end of our audit period, IAL never reimbursed Riverside for any of these payments.

Regarding this matter, Riverside's Executive Director stated that Riverside paid the premiums on the policies of his former business associate so that the Executive Director could buy out his former Business partner's share in IAL. In support of this assertion, Riverside's Executive Director provided us with a copy of the February 26, 2001 minutes of the meeting of IAL's Board of Directors which state, in part:

> *Resolved, that the [sic] Corporation is authorized to enter into a Split Dollar Agreement with …[former business associate], a copy of which is appended hereto, and in consideration therefore, …[name of former business associate] will surrender his 100 shares of Stock back to the Corporate treasury.*

Riverside's Executive Director stated that he did not think it was a problem to use Riverside's state funds for this purpose since Riverside was recording the premiums it paid on behalf of this individual as a receivable in Riverside's accounting records. However, given that there was no formal written contract between Riverside and IAL or Riverside's former business partner that ever required repayment of these funds and that, as of the end of our audit period, none of these funds were ever repaid by IAL to Riverside, these payments clearly represent a misuse of state funds. Consequently, the $348,623 in total premium expenses that Riverside charged against its state contracts for these insurance policies represents unallowable and nonreimbursable expenses. The following table summarizes how Riverside allocated the expenses associated with these insurance premiums.

Summary of Funds Used to Pay Insurance Premiums

		Allocation of Costs			
Fiscal Period	Amount	Commonwealth Contracts	MA Cities/towns	State of NH	Other Funding*
Prior to Audit Period[4]	$440,243	$264,146	$136,475	$ 44,024	($4,402)
2002	69,049	41,429	21,405	6,905	(690)

[4] Riverside officials were not able to provide us with documentation to substantiate how the costs of these insurance premiums were allocated by the agency prior to our audit period. Consequently, for our calculations, we used the percentages allocated by Riverside during our audit period as an estimate of how these expenses were allocated during the period prior to the period covered by our audit.

Fiscal Period	Amount	Commonwealth Contracts	MA Cities/towns	State of NH	Other Funding*
2003	25,265	12,633	9,095	3,537	0
2004(through 3/31/04)	55,300	30,415	12,719	12,166	0
Total	$589,857	$348,623	$179,694	$ 66,632	($5,092)

*Funds were taken from Riverside's surplus funds and used to offset the funding of these expenses.

Subsequent to the completion of our audit fieldwork, a representative of Riverside's private accounting firm stated that as of June 30, 2004 IAL owed Riverside $90,376.75 relative to various expenses, including the aforementioned insurance premiums Riverside paid on IAL's behalf. According to the schedule provided by Riverside's accounting firm, as of June 30, 2005, IAL had incurred additional charges of $2,590.85 but had repaid Riverside $59,371.17 leaving an outstanding balance that IAL owed Riverside as of this date of $33,596.43. However, since this information was provided to us after the completion of our audit work it was not possible to verify its accuracy. Moreover, any repayment of funds by IAL should be made to the Commonwealth and not Riverside until such time as the agency fully repays the $348,623 in state funds that it inappropriately used to purchase the life insurance policies for the former business associate of Riverside's Executive Director.

Recommendation

In order to address our concerns relative to this matter, we recommend that DSS recover from Riverside and its Executive Director the $348,623 in unallowable insurance premium expenses Riverside charged against its state contracts during our audit period. In the future, Riverside should take measures to ensure that state funds are only used for their intended purposes.

Auditee's Response

In response to this audit result, a law firm representing Riverside stated, in part:

> *First, the purchase of the life insurance policies was not a purchase of "investments" - they were insurance policies. . . .Moreover, they were not an improper use of state funds. The policies on the Executive Director were structured so that when there was a payout, the distribution would be made after repaying NEHS for the premiums that had been paid on the policy. Consequently, any funds that had been applied to the premiums would eventually be repaid, with a net effect of $0.00. In fact, NEHS was well aware of and had approved this benefit. The Executive Director had a written agreement with NEHS to provide for a split-dollar policy. In addition, Riverside believes that the payment of the Executive Director's policies was reasonable and in compliance with OSD regulations. Pursuant to 808 CMR 1.05(9), fringe benefits are permissible unless they are considered to be excessive "in light of salary levels and benefits of other comparable Contractors . . . ." The Board of Directors was aware that in order to continue the employment of the Executive Director, they would have to provide a fringe benefit package that was competitive with the educational marketplace. Riverside maintains that the benefits package offered to the Executive Director was reasonable and necessary to retain his services, and there has been no finding that the fringe benefits were excessive in light of salary levels benefits of other comparable Contractors.*
>
> *Meanwhile, the policy for the Executive Director's former business associate was unrelated to the operation of Riverside, and irrelevant to this audit because* ***none of the premiums for this policy were charged to state contracts.*** *As the Auditor knows, at one time IAL was owned by the Executive Director and his business associate. Part of the purchase price when the Executive Director acquired the business associate's interest was an agreement that IAL would continue to pay the premiums on the life insurance policies of the business associate. IAL did not have a checking account, however, so it was not convenient for IAL to make the payments. Consequently, the parties agreed that Riverside could continue to make the insurance premium payments on behalf of IAL, and that such payments would be accounted for as a receivable to Riverside. Subsequent to the audit (post 3/31/04) IAL made a significant payment on the amount owed to Riverside. As of June 30, 2004, IAL only owed Riverside slightly more than $34,000.*
>
> *In addition, the amount of the premiums set forth in the draft audit was far in excess of what Riverside actually paid during the audit period, and it is unclear from the draft auditors' report how the $451,052 in total payments was calculated.*

Auditor's Reply

As stated in our report, contrary to state regulations, Riverside used $348,623 in state funds to purchase life insurance policies for Riverside's Executive Director and a former business associate of the Executive Director, who was not even an employee of Riverside. The representative from WBG with whom we spoke regarding these policies indicated that for this

type of insurance, money is invested in the stock market, and that therefore variances in the policy's cash value can occur. Specifically, the policy states, in part:

> *The amount and/or duration of the death benefit and other values provided by this policy are based on the investment experience of the separate accounts(s). Values are variable, may increase or decrease, and are not guaranteed as to fixed dollar amount. Depending on the performance of the investment options, you could lose your entire investment; as a result, there could be no death benefit unless additional premium payments are made to keep the policy in force.*

According to the representative from WBG, these policies also accumulate cash values that can be accessed by the policy holders. Webster's Third New International Dictionary offers one definition of investment as "an expenditure of money for income or profit or to purchase something of intrinsic value." Clearly, the policies in question have both substantial intrinsic and monetary value and, according to the language in the policies themselves, they are investments and are appropriately and accurately characterized as such in our report.

Contrary to what Riverside states in its response, state funds were in fact used to pay the insurance premiums of the former business associate of Riverside's Executive Director. Moreover, during our audit period these amounts still appeared as a receivable on Riverside's financial statements. Consequently, these payments and the related receivable were clearly related to the operation of Riverside. Riverside's Executive Director does not dispute the fact that state funds were used to pay the expenses in question. Further, Riverside's financial records do not segregate state from non-state funds. Rather, all revenues are grouped together and expenses are paid using these pooled funds. Consequently, when an expense is paid for by Riverside, the source of the funds used to pay these expenses is proportional to the revenues received from each funding source. In this case, approximately 55% of the revenues in the Riverside's revenue pool were state funds; therefore, we correctly questioned 55% of the payments for the policies as being paid for with state funds.

Contrary to what Riverside states in its response, the use of state funds to pay for these insurance policies was clearly improper. Further, based on our review of Riverside's records, we determined that, contrary to Riverside's assertions, that there is no agency policy nor were we provided with any formal written employment contract between Riverside and its Executive Director that provided for the provision of these benefits to this individual. Therefore, the $138,805 that Riverside charged against its state contracts to provide this fringe benefit to its

Executive Director represented nonreimbursable expenses in accordance with 808 CMR 1.05(9)(a). In addition, we found that the payments made by Riverside on behalf of its Executive Director's former business associate were recorded by Riverside in its financial statements as a receivable from IAL. However, according to agency records, there was no formal written agreement between Riverside and IAL that ever required repayment of these funds. As of the end of our audit period, IAL never reimbursed Riverside for any of these payments. In its response, Riverside contends that the former business partner of the agency's Executive Director has repaid a significant amount of the funds that Riverside used to pay for the premiums on his policy. However, Riverside did not provide us with any documentation to substantiate this claim or identify how any of these funds, if repaid, benefited the state-funded students in Riverside's programs. Moreover, the funds provided to Riverside by the Commonwealth were supposed to be used to fund program services and not pay the expenses of individuals who are not even employed by the agency. Regardless of whether this individual repaid Riverside some of these funds or whether IAL "did not have a checking account," using state funds to pay for such non-program- related-expenses is inappropriate and unallowable.

Riverside contends that it was necessary to provide this benefit to its Executive Director in order to retain his services. However, Riverside did not provide us with any documentation to substantiate that the agency's board either discussed or evaluated the level of the Executive Director's compensation during the period covered by our audit. In fact, as noted in Audit Result No. 5, there was nothing in the Executive Director's personnel file that indicated that the board had ever formally evaluated the Executive Director's performance as required by state guidelines. Further, we were not provided with any documentation to indicate that the agency's Executive Director had any official dialogue with the board regarding his dissatisfaction with his level of compensation.

In its response, Riverside contends that its Executive Director entered into an agreement whereby Riverside would pay the premiums on the insurance policies for his former business partner because "IAL did not have a checking account", and the amounts paid by Riverside would be recorded by the agency as a receivable due from IAL. However, to date, Riverside has not been able to give us a copy of any such agreement. Also, the receivables Riverside was recording as being due from IAL did not include any interest charges for the use of these funds by an outside party, which effectively provided this individual with interest-free loans. Further, it

is unreasonable for us to believe that IAL's lack of a checking account precluded the Executive Director's former business partner from using some other means (e.g., a personal checking account or credit card) to pay for these premiums himself.

Finally, as stated in our report, Riverside did not maintain complete and accurate records relative to the payments it made for these insurance premiums, including those made for the Executive Director's former business partner, other than the receivable from IAL in its financial statements. Consequently, the figure in our report for the premiums paid by Riverside for these policies prior to the period covered by our audit were obtained from the WBG insurance agent who handled this account. If Riverside had adequately maintained all of the records relative to these transactions, as it is required to do by state regulations and the terms and conditions of its state contracts, we would have been able to use its records to accurately calculate the premium payments in question.

3. QUESTIONABLE CASH MANAGEMENT ACTIVITIES CONDUCTED BY RIVERSIDE'S EXECUTIVE DIRECTOR RESULTED IN UNDOCUMENTED AND/OR INADEQUATELY DOCUMENTED EXPENSES BEING CHARGED BY RIVERSIDE AGAINST ITS STATE CONTRACTS. INCLUDED IN THESE EXPENSES WERE $26,717 IN NON-PROGRAM EXPENSES AND $4,454 IN DUPLICATIVE CHARGES

We found that Riverside's Executive Director wrote himself weekly agency checks which during averaged $3,200 our audit period. According to the Executive Director, he cashed these checks and used the funds to purchase items for Riverside's programs. However, during our audit, we reviewed the documentation Riverside was maintaining relative to $423,576 in checks cashed by Riverside's Executive Director and noted numerous concerns. First, there was no documentation to substantiate that $15,898 of these expenses were ever incurred. Additionally, we found that an additional $216,142 of these expenses that were charged by Riverside against its state contracts were inadequately documented of which $26,717 appeared to be non-program-related in that they appeared to be for the personal use of Riverside's Executive Director and his wife. Examples of non-program-related expenses include weekly receipts for food purchased from restaurants, grocery stores, and a delicatessen in the Peabody and Lynnfield area, where Riverside's Executive Director and his wife live. These purchases were for food items such as various deli meats, cooked shrimp, lobster rolls, lobster meat, tenderloin steaks, and a total of $342 in beer and wine. According to program staff, these items were never provided to the students in Riverside's program. Of particular concern, is that we found at least 46 instances totaling $4,454 where Riverside's Executive Director appeared to resubmit receipts that he used

as support to substantiate these weekly expenditures and receive additional duplicative reimbursements from Riverside. According to state regulations, expenses that are duplicative, undocumented, or non-program-related are unallowable and nonreimbursable under Riverside's state contracts.

OSD regulations 808 CMR 1.05(12) and 808 CMR 1.05(26) identify the following as nonreimbursable costs under state contracts:

> *1.05(12) Non-Program Expenses. Expenses of the Contractor which are not directly related to the social service Program purposes of the Contractor.*
>
> *1.05(26) Undocumented Expenses. Costs which are not adequately documented in the light of the American Institute of Certified Public Accountants statements on auditing standards for evidential matters.*

Further, 808 CMR 1.04(1) promulgated by OSD states:

> *The Contractor and its Subcontractors shall keep on file all data necessary to satisfy applicable reporting requirements of the Commonwealth (including DPS [now OSD], 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. . . . If the Contractor or a Subcontractor receives any federal funds from the Commonwealth, directly or through subcontract, the Contractor or Subcontractor shall also keep data necessary to satisfy Federal Office of Management and Budget (OMB) Circular A-133, or successor provision and shall also maintain books and records in accordance with OMB Circular A-110 and OMB Circular A-122, or successor provisions.*

During our audit, we noted that between July 1, 2001 and March 31, 2004, Riverside issued weekly checks totaling $423,576 made payable to Riverside's Executive Director, of which $232,040 was charged by Riverside against its state contracts. When asked about these checks, Riverside's Executive Director stated that he cashes these checks and uses these funds to pay for weekly program expenses, primarily food. He further stated that the school has tried different food service options in the past that did not work, and that he finds it easier to simply use an advance fund system to pay for food and other program expenses. The Executive Director indicated that each week, he reviews the receipts for food and other program expenses of the prior week, and uses this information to estimate program expenses for the upcoming week. He

then instructs Riverside's Bookkeeper (his wife) to issue him a check for this estimated amount, which he cashes and distributes, as necessary, to program staff members, who make the necessary purchases.

In order to substantiate the Executive Directors assertions, during our audit we spoke with Riverside's Director of Program Services, who is responsible for overseeing all program activities, including the purchase of food items. The Director of Program Services stated that each week a menu is prepared for the program, as well as an estimate of the cost of purchasing the food items necessary to provide the meals to the students in the program in accordance with this menu. The Director indicated that he then notifies Riverside's Executive Director of the estimated costs, and that the Executive Director gives him sufficient cash to purchase these food items.

Given the amount of state funds being disbursed by Riverside in this manner, we assessed the controls Riverside has established over the use of these funds, and found them to be inadequate. Specifically, Riverside does not have any written policies and procedures relative to the use of these funds. Further, Riverside's Bookkeeper, who issues the checks to Riverside's Executive Director, is his wife, and the Executive Director authorizes and approves all checks without any board approval or oversight.

Based on these internal control deficiencies, we reviewed all the documentation relative to the 146 checks totaling $423,576 that were cashed by Riverside's Executive Director during the period July 1, 2001 through March 31, 2004 and noted the following problems:

- We reconciled the dollar value of the 5,820 receipts maintained by Riverside that supported the 146 checks made payable to Riverside's Executive Director and noted that for each of the 146 weeks, the amount of receipts was less than the amount of the check cashed by the Executive Director. The difference between the checks cashed by the Executive Director and the total receipts was $15,898 ($5,501 for fiscal year 2002, $6,023 for fiscal year 2003, and $4,374 for fiscal year 2004 (through March 31, 2004).

- There was inadequate documentation to substantiate all of the remaining $407,678 in expenditures. Examples of inadequately documented expenses include credit card monthly statements without original receipts indicating the nature of the purchase, who made the purchase, or how the purchase benefited Riverside's state-funded programs; food receipts that did not indicate what program received the food; ticket stubs from movie theaters with no indication of who attended the movies; and $3,296 for gift cards

with no indication of who received these cards or how they benefited Riverside's state-funded programs.

- We found expenditures totaling $26,717 that appeared to be non-program-related (personal) in nature. Specifically, during our audit we spoke with Riverside's Director of Program Services as well as several other program staff members about where they purchase their food for the program. In response, these individuals stated that they make all of their large food purchases at Sam's Club in Nashua, New Hampshire and that they make all of their smaller purchases (e.g., a loaf of bread) locally at the Market Basket in Lowell. However, we found that there were weekly receipts for food purchased from restaurants, grocery stores, and a delicatessen located in the Peabody and Lynnfield area where Riverside's Executive Director and his wife live. These purchases were for food items such as various deli meats, cooked shrimp, lobster rolls, lobster meat, tenderloin steaks, and a total of $342 in beer and wine that, according to program staff, were never provided to the students in the program. We also found other expenses such as $292 for car washes in Reading, even though Riverside does not have any programs in Reading. Finally, we found a number of invoices in which meals for only two individuals were purchased, clearly indicating that these purchases were personal in nature.

- We found 46 instances totaling $4,454 where Riverside's Executive Director submitted documentation that he used to substantiate how he spent the weekly funds he received to receive additional reimbursements from Riverside. For example, Riverside does business with a company called Por-Shun Inc., which delivers milk to Riverside to be used by students in the program. On July 29, 2003, Por-Shun delivered milk and gave the Executive Director an invoice of $95.07. The Executive Director paid this invoice directly by agency check but also subsequently used this invoice as supporting documentation for the petty cash check that he wrote to himself that week. In another instance, on June 22, 2003, Riverside purchased 80 tee shirts costing $332 from Lull and Hartford Inc., of Lowell. Riverside paid for this expense directly by check, but Riverside's Executive Director used the invoice for these tee shirts as supporting documentation for the petty cash check he issued to himself on June 22, 2003. We also noted that the Executive Director used a photocopy of this same $332 invoice as supporting documentation for the petty cash check he issued to himself on July 9, 2003, which indicates a triple billing for this single expense. In another instance, we noted that on January 21, 2002, Riverside issued a check for $409.98 to Riverside's maintenance staff person to purchase a refrigerator and vacuum bags for the program. Riverside's Executive Director subsequently used the receipts for the purchase of these items to substantiate the check he issued to himself on February 6, 2002.

- We also noted an unusual pattern of how these weekly checks were being cashed. Specifically, on 71 occasions involving checks totaling $206,793, Riverside's Executive Director endorsed the check and cashed it at the bank (Fleet) that maintains Riverside's corporate account. However, in 27 instances totaling $77,351, Riverside's Executive Director endorsed the check, put his personal bank account number on the check and cashed it at the bank where he maintained a personal bank account. Similarly, on 48 occasions for checks totaling $136,264, Riverside's Executive Director and his wife endorsed the check put their personal bank account number on the check and cashed it at the bank where they had a personal bank account. Although this pattern of check cashing

> appeared to be unusual, we did not have access to Riverside's Executive Director's bank statements and therefore could not determine if any of these funds were directly deposited into his personal accounts.

Regarding this matter, Riverside's Executive Director stated that he believed it was cost effective for him to handle food and other program purchases in this manner because it reduced Riverside's accounting costs. Regarding the discrepancies between the receipts and the checks issued to him, the Executive Director stated that he does his best to document all purchases, but sometimes documentation gets misplaced.

Recommendation

In order to address our concerns relative to this matter, we recommend that DSS recover from Riverside the $232,040 in undocumented, non-program-related, and duplicative petty cash expenses it charged against its state contracts during the period covered by our audit. Further, DSS, in conjunction with OSD, should conduct its own review of the petty cash expenses charged by Riverside against its state contracts during the four fiscal years prior to those covered by our audit. Based on this review, DSS should recover from Riverside any funds it deems appropriate. In the future, Riverside should implement adequate controls over its petty cash funds.

Auditee's Response

In response to this audit result, a law firm representing Riverside stated, in part:

> *Riverside also objects to the incorrect implication that its cash management activities resulted in "at least $232,040 in . . . duplicative expenses . . . ." The draft audit report itself does not support such a statement. First, the report indicates that the expense charge to the state was $232,040, so it is unclear why it is suggested that there may be more by stating that the amount in controversy is "at least" $232,040. Moreover, by the auditor's own calculations there was only $15,898 worth of expenses with no documentation, $26,717 in "non-program related" expenses, and $4,454 in "duplicate" expenses, for a total of $31,171. Reserving for the moment Riverside's disagreements with several of the auditor's findings and conclusions as to these amounts, as 54.78% of the total expenses were charged against state contracts, this means that only $17,075 ($31,171 x 54.78%) should be at issue. To question whether any of the $232,040 expensed to state contracts was put to proper use is absurd and unreasonable, as the auditors clearly witnessed first-hand that the program, students, staff, and facilities existed. The program was being paid for by something.*
>
> *Riverside's use of state funds was proper, and at all times furthered the purposes of its charitable mission. Riverside cares for and educates 65 special needs boys and young men, with all the attendant costs associated with a residential program. Riverside is largely self-sufficient, and during the audit period actually boasted an unbelievably low*

expense cost of $50 per week per student. That is remarkable in this industry. In fact, because of its efficiencies it costs Riverside less to feed its students, staff and visitors itself than it would if Riverside hired a food service. Riverside should be commended - not brought under suspicion - for its efforts to save the Commonwealth money.

Riverside has daily food and operations expenses that are met by the individual site managers. As Riverside has four different sites, it is more efficient for the Executive Director to make a cash advance then distribute the proceeds to the site managers to allow them to make purchases for their own facilities. At other times, such as for staff functions, the Executive Director may purchase the food or supplies himself.

While the Executive Director made reasonable efforts to obtain receipts for all of the site managers' purchases, at times it was difficult or impossible to obtain an original receipt. For example, during the course of taking students to a movie, in the bustle of a theatre and while trying to keep any eye on several, highly active special needs students, a site manager may forget to ask for a receipt. Nonetheless, of the total. . . [weekly] checks examined (over $423,576), over 96% ($407,678) had some type of back up. While the Executive Director will take precautions in the future to ensure that original receipts for each purchase are obtained, and the Board of Directors will be provided and have an opportunity to review detail of all facility expenses on a monthly basis, failure by staff to obtain or turn in an original receipt does not render an expense unallowable, especially when there is secondary evidence of payment.

In addition, the report construes "proper" uses of funds too narrowly. . . . In addition, purchases of items from grocery stores and a delicatessen were made by the Executive Director, but they were for use at staff meetings or functions congratulating or thanking the staff (i.e., the beer and wine purchased was for a staff function). This is a common and appropriate business practice.

The Executive Director cashed checks at both the school's bank and his own bank. Since the reimbursements were done on a weekly basis, it was sometimes more convenient to cash the checks at a bank closer to his home. The school should not be penalized and no impropriety should be implied simply because the Executive Director used a banking facility close to his residence. Moreover, the location of the bank where the Executive Director cashed the advance checks is irrelevant; by the auditors' own schedule, they examined "petty cash" slips that had documentation for 96% of the reimbursements...

In addition, Riverside included 21 statements from employees (five of whom provided more than one statement) in support of the assertions made within the agency's response. Specifically, these statements, dated between May 4 and May 9, 2005, indicated that employees received bonuses, staff anniversary gift cards, special luncheons, and flowers. In general, these statements indicated that these items bolstered staff morale and helped maintain staffing levels. Further, Riverside provided the following additional comments:

- *Many of the Riverside staff reside in the Peabody and Lynnfield area, not just the Executive Director. It would not be uncommon for someone at one of the facilities to call a staff member before they reported for work to ask them to pick up a supply that the facility had run out of. Consequently, receipts could have come from virtually anyone or anywhere, and should not be considered "unallowable" merely because of the location of the purchase.*

- *Original source documentation was provided with the majority of expense claims that Riverside submitted. . . .The Executive Director often did rely on monthly credit card statements to track program purchases, but by putting as many purchases through the credit card as possible this was viewed as a method for him to have greater control over tracking the use of program funds. Failure to cross-reference original receipts with the credit card invoices may not be seen to be a gap in the system, but it would only be an issue if there was a question whether there were duplicate expense entries for the same purchases. As to the gift cards, these were usually purchased for the staff as a thanks or congratulations for work well performed. They are in the nature of compensation/bonus, designed to save the program and state money by increasing employee morale, and reducing turnover and training costs.*

- *Most, but not "all" of smaller purchases were local. But several employees, including the Executive Director, sometimes made purchases near their homes or on the way to work for use at the facilities. . .Most of these purchases were provided to the staff during meetings or for functions. . . .If the Executive Director had use of one of the facility's vehicles, he may have it cleaned traveling to or from work. . . .The Executive Director sometimes expensed meals when meeting with a Board member, a facility manager, or certain vendors.*

- *Riverside acknowledges that these entries need to be adjusted on the cost reports, but it is unfair to characterize them otherwise.*

Auditor's Reply

Our report does not state that we identified $232,040 in duplicative expenses, but rather correctly characterizes these expenses as highly questionable and/or duplicative.

Our report makes it abundantly clear why we are questioning at least $232,040 in expenses. Specifically, our report clearly states that during the period covered by our review, the Executive Director wrote himself checks totaling $423,576, of which $232,040 was charged by Riverside against its state contracts. The audit result also clearly states that we identified problems with all of these expenses and hence we question the entire $232,040. We qualify this amount by saying "at least" because, according to Riverside officials, the Executive Director's practice of writing himself checks also took place during the period prior to our review (July 1, 2001 to March 2004). Consequently, a review of expenses prior to July 1, 2001 may reveal additional questionable expenses in this area.

Contrary to what Riverside asserts in its response, we identified a number of problems with the expenses we reviewed in this area, which raises questions about their propriety. Regardless of the agency's weekly per-student cost, which Riverside contends is low, Riverside is required by state regulations and the terms and conditions of its state contracts to implement adequate internal controls over all of its activities, and to maintain records to document that state funds

were being properly safeguarded against abuse and misuse, and that these funds were being expended for their intended purposes. In the instances cited in this audit result, Riverside failed to meet these requirements. Consequently, our report appropriately questions those expenses that were not adequately documented, were duplicative, and/or did not appear to be for program-related purposes. Riverside contends that that the agency was able to provide us some documentation for most of the expenses. However, in most cases the documentation provided was a credit card statement with a note written on the statement by a Riverside staff person indicating what was purchased. This documentation is clearly inadequate, since it does not allow us to verify the items actually purchased and how they related to Riverside's programmatic activities. We fail to see how a competent accounting staff would not have known that it is important to retain all of the source documents associated with each purchase, as required by state regulations, in order to properly document the agency's expenditures. Even when items are purchased on the Internet, invoices are generated that can be printed out and retained by the purchaser that, at a minimum, shows the date and items purchased and the amounts of each purchase.

In its response, Riverside provides explanations as to the business nature of some of the expenses we identified as being questionable. For example, in its response, Riverside states that the food and alcohol purchases made by the Executive Director and his wife were in fact for staff meetings and functions. However, the documentation relative to these purchases did not support this claim. Moreover, the number and types of items purchased raises into question the explanation provided by Riverside in its response. Specifically, some of the items (e.g., tenderloin steaks, lobster meat) were purchased in a quantity sufficient enough to feed only two people, as opposed to the 50 students in Riverside's programs. Some of these items also had to be cooked, so we question how practical these would be for staff meetings. Also, in its response, Riverside touts how little it spends per student each week on food. However, it is apparently not concerned with how much it spends on food for staff meetings by buying such expensive food items. Moreover, not only are the costs of beer and wine unallowable expenses under state contracts, but we also question the logic of serving alcohol during business meetings if this was in fact the case. When we asked about these purchases, Riverside staff stated that students were never provided with these items, and never mentioned that these items were used at staff meetings.

In its response, Riverside comments that some of the purchases were for items used by its staff. However, if these purchases were for personal items, they are non-program-related in nature and unallowable and nonreimbursable under Riverside's state contracts. Further, this does not mitigate Riverside's responsibility to ensure that all of its expenses are properly documented as required by state regulations and the terms and conditions of its state contracts. The system set up by the agency's Executive Director to monitor these expenses clearly lacked the controls that should have been in place to ensure that Riverside and Commonwealth funds would be adequately safeguarded against abuse and/or misuse.

Finally, we fail to see how it is more efficient for the agency's Executive Director to give himself cash and distribute this cash as necessary to each program as opposed to setting up a system (e.g., credit cards) whereby each program could purchase items they needed on an as-needed basis.

4. INADEQUATE CONTROLS OVER AGENCY PROGRAM AND ADMINISTRATIVE EXPENSES RESULTING IN INADEQUATELY DOCUMENTED/UNDOCUMENTED EXPENSES TOTALING $264,468, INCLUDING WHAT APPEARS TO BE NON-PROGRAM-RELATED EXPENSES TOTALING $15,138

We found that, contrary to the requirements of Generally Accepted Accounting Principles (GAAP), Riverside does not have adequate controls over the authorization and payment of agency program and administrative expenses. As a result, we found that between fiscal year 2002 through March 31, 2004, at least $264,468 in administrative expenses charged by Riverside against its state contracts were inadequately documented. Moreover, $15,138 of these expenses did not appear to be related to the social service program purposes of Riverside's state-funded contracts. Examples of non-program-related expenses charged to state contracts include: two weekend season tickets to the Boston Red Sox regular season and post-season games for three seasons totaling $12,465, food and gifts for employees totaling $3,783, payments to a dentist totaling $3,791, various donations totaling $1,050, and $5,110 in professional fees incurred by IAL, Riverside's related-party organization. According to state regulations, expenses such as these that are inadequately documented or not directly related to the program purposes of Riverside's state-funded programs are unallowable and nonreimbursable to the state. We also found at least four instances in which the items claimed to have been purchased according to Riverside's records were not the actual items purchased, according to the vendors we contacted. For example, on February 11, 2004, Riverside claimed that it paid $145 to 1-800-Flowers.com to

purchase decorations for the school. However, the vendor's records indicated that the item purchased was a Valentine's Day flower arrangement for Riverside's Executive Director's wife and his daughter.

Generally Accepted Accounting Principles (GAAP) requires entities such as Riverside to establish adequate internal controls over all aspects of their operation, including the processing of administrative and program expenses. According to GAAP, these entities should establish and implement an adequate internal control system within the organization to ensure that goals and objectives are met; resources are used in compliance with laws, regulations, and policies; assets are safeguarded against waste, loss and misuse; and financial data is maintained, reported, and fairly disclosed in reports.

During our audit, we first assessed the system of internal control Riverside had established over the payment of administrative and program expenses. Our review indicated that Riverside had not established any formal written policies and procedures relative to the processing of agency expenses. Also, Riverside staff did not conduct an independent review of administrative and program expenses prior to payment to ensure their reasonableness. Further, Riverside did not utilize a payment voucher system to request payment of its expenses, and therefore the documentation Riverside maintains to support its expenses lack a date stamp, an accounting code indicating the accounts to which the expenses were charged, and approval signatures. We also found a lack of segregation of duties relative to the processing of administrative and program expenses, in that the Executive Director and his wife, Riverside's Bookkeeper, are responsible for the authorization, payment, and recording of these expenses, the issuance of checks to pay the expenses, and the maintenance of Riverside's bank records relative to these payments.

During our audit period, Riverside charged and was reimbursed by state agencies a total of $3,076,889 for program and administrative expenses. We reviewed documentation Riverside was maintaining relative to $1,247,616, or 41% of these expenditures, consisting of expenditures of $444,949, $458,031, and $344,636 for fiscal years 2002, 2003, and 2004, respectively, of which $767,211 was reported on in other findings. Based on our review, we noted a number of problems pertaining to the $480,405 balance, as detailed in the following sections.

a. Inadequately Documented Expenses totaling $264,468 Charged to State Contracts

As mentioned above, GAAP requires entities such as Riverside to establish adequate internal controls over all aspects of their operations, including the processing of administrative and program expenses.

Further, the Operational Service Division (OSD), the state agency responsible for regulating and overseeing the activities of contracted human service providers such as Riverside, has promulgated regulations, 808 Code of Massachusetts Regulations (CMR) 1.05, with which all contracted human service organizations must comply. Section 16 of this regulation identifies the following costs as being nonreimbursable costs under state contracts:

> *1.05(26) Undocumented Expenses. Costs which are not adequately documented in the light of the American Institute of Certified Public Accountants statements on auditing standards for evidential matters*

Our testing indicated that, contrary to these requirements, Riverside charged $264,468 against its state contracts for expenses that were adequately documented. In fact, the supporting documentation maintained by Riverside relative to these expenses was often a photocopy or facsimile copy of an invoice or statement, and on occasion, just a handwritten note from the Executive Director instructing Riverside's Bookkeeper to pay a certain amount to various people and businesses. In addition, we found many instances in which Riverside did not maintain proper backup documentation, such as receipts indicating what was purchased, or packing slips noting who received the items and confirming that the purchased items were received.

b. Non-Program-Related Expenses Totaling $27,111, of Which $15,138 Was Charged to Riverside's State Contracts

OSD has promulgated 808 CMR 1.05, Sections 1 and 12, which identifies the following costs as being nonreimbursable under state contracts:

> *(1) Unreasonable Costs. Any costs not determined to be Reimbursable Operating Costs as defined in 808 CMR 1.02 or any amount paid for goods or services which is greater than either the market price or the amount paid by comparable Departments or other governmental units within or outside of the Commonwealth.*
>
> *(12) Non-Program Expenses. Expenses of the Contractor, which are not directly related to the social service Program purposes of the Contractor.*

Our review of $480,405 in expenditures revealed that, contrary to these regulations, Riverside expensed at least $27,111 in non-program expenses including its state contracts.

Non-Program-Related Expenses

July 1, 2001 through March 31, 2004

Payee	Total Payments	Description
Boston Red Sox	$12,465	Two season tickets for regular season and post-season games for 2001, 2002, and 2003. The tickets were in the name of Riverside's Executive Director's business associate.
James Showstack, DDS	3,791	Three payments (two in fiscal year 2002, one in fiscal year 2004) to a dentist located in Wakefield, MA. Note attached states that it is for the portion of dental service expenses incurred by various employees that was not reimbursed by insurance.
Food and Gifts for Employees	3,783	Food and gifts for employees, including food for a Christmas party totaling $763, gifts and gift certificates for devoted service, and $305 for an administrative luncheon at a golf resort.
Institute Associates of Lowell	456	Fee due to the Commonwealth for organizing tax filing.
Department of Revenue	456	Quarterly tax bill for IAL.
Various	5,110	Professional fees incurred by IAL
Various	1,050	Donations
Total	$27,111	

Given the lack of internal controls over these expenditures, we wanted to confirm that certain expenses paid for by Riverside were in fact, what was indicated in Riverside's documentation for these expenses. In order to do this, we judgmentally selected four transactions, contacted the vendors who provided the goods or services, and reviewed other available documentation to confirm what was actually purchased by Riverside. For all four of these transactions, we found that the invoice Riverside paid did not appear to accurately represent the goods and services actually purchased. These four transactions are summarized below:

Date	Amount	Merchant	Location	Item per Riverside's Records	Item Purchased per Vendor or Other Source of Confirmation
2/11/04	$64	1800Flowers.com	NY	Decorations for school	A Valentine's Day arrangement for the daughter of Riverside's Executive Director.

2/11/04	81	1800Flowers.com	NY	Decorations for school	A Valentine's Day arrangement the wife of Riverside's Executive Director.
1/23/02	189	Intelligence Report	Maryland	Newsletter for school	A subscription for an investment/ advice newsletter
2/28/02	784	Herrington Corp. Catalog	NH	Auto mats and batteries for the van	Per this company's catalog, this company sells items for golf and travel enthusiasts
Total	$1,118				

Regarding these matters, Riverside's Executive Director stated that he believed the supporting documentation for the expenditures in question was adequate and that all the expenses in question were appropriate.

Recommendation

DSS should recover from Riverside the $264,468 in undocumented and non-program-related administrative and program expenses that it charged against its state contracts during our audit period. Further, DSS, in conjunction with OSD, should conduct its own review of the administrative and program expenses billed by Riverside against its state contracts during the periods prior to our audit period and, based on this review, recover any additional funds they deem appropriate. In the future, Riverside should establish more effective internal controls over agency program and administrative expenses. For example, it should maintain adequate records to support such transactions, including purchase orders, detailed receipts, signatory approvals, and statements as to the purpose and reasonableness of expenditures.

Auditee's Response

In response to this audit result, a law firm representing Riverside stated, in part:

> *Riverside acknowledges that it could improve its bookkeeping system and procedures. Nonetheless, there is nothing to suggest that the majority of the expenses reported in this section were not used for program-related purposes. Riverside believes it is important to emphasize the distinction between "undocumented" and "inadequately documented." The former is a statement of fact; the latter a statement of opinion. In fact, it is not that Riverside failed to provide documentation of its expenditures - in the majority of cases, it did so. What Riverside is asking the auditors to recognize when they review the adequacy of the supporting documentation is the plain truth that it would be nearly impossible to keep the program costs at the lowest level in the state if Riverside were misallocating funds. Simply, if significant funds were not used for program purposes there would have been a much higher overall cost to run Riverside's program.*

The fact that Riverside kept its costs extremely low is the best evidence that the program was efficiently managed, and that very few funds, if any, went to non-program uses.

Riverside provided additional comments to this audit result, as follows:

- *These [two seasons Red Sox tickets] were a weekend-only ticket package, and the tickets were used to take students to games.*
- *[IAL tax filing fee] This was an advance to IAL for an audit fee – it has been repaid in full by IAL.*
- *From time to time, the Executive Director purchased flowers for the female employees of Riverside, again for morale-boosting and to show appreciation for their hard work. The Executive Director's wife and daughter were employees of Riverside, and also received flowers on this occasion.*
- *There is nothing inherently improper about using a copy of an invoice. Although an original is ideal, a copy is only problematic if there is evidence of alteration or duplicate invoices submitted. Indeed, the AICPA statements on auditing standards for evidential matters do not require any particular form of evidence. Moreover, the report states that the supporting documentation was "often" a copy, but does not indicate what was produced when it was not a copy. If an original invoice was used, it is unclear why the entry supported by the original invoice would be questioned.*

In addition, Riverside made the following specific comments relative to the $27,111 of non-program-related expenses we identified:

Item	Riverside Comment
Valentine's Day Flowers for Executive Director's wife and daughter	Mistaken entry
Intelligence Report Subscription	The subscription was purchased in connection with a business course being taken by the students. The newsletter was used by the student.
Floor mats and batteries for the van	A copy of the catalogue showing the mats ordered is attached….

In addition, Riverside included 21 statements from employees in support of various assertions made by Riverside in its response indicating that employees received bonuses, staff anniversary gift cards, special luncheons, and flowers that bolstered staff morale and helped maintain staffing levels.

Auditor's Reply

We agree with Riverside's comment that it should improve its bookkeeping system and procedures. However, we do not agree with Riverside's position that there is nothing to suggest that the funds in question were not used for program-related purposes. The fact of the matter is that Riverside is required to maintain documentation to substantiate that all of the expenses it bills against its state contracts were incurred and were related to the social service program purposes of the agency. If the agency fails to maintain such documentation, as did Riverside, then it is reasonable to question the nature of the expense, as was done during our audit. According to state regulations, there effectually is no real distinction between inadequately documented and undocumented expenses, as evidenced by the following regulations:

> *1.05(26) Undocumented Expenses. Costs which are not adequately documented in the light of the American Institute of Certified Public Accountants statements on auditing standards for evidential matters*

As can be seen by the wording in this regulation, if an expense is inadequately documented it is in effect, undocumented in terms of its being allowable. As stated in our report, our testing indicated that contrary to these regulations, Riverside charged $264,468 against its state contracts for expenses that were inadequately documented. In fact, the supporting documentation maintained by Riverside relative to these expenses was often a photocopy or facsimile copy of an invoice or statement, and occasionally just a handwritten note from the Executive Director instructing Riverside's Bookkeeper to pay a certain amount to various people and businesses. In

addition, we found many instances in which Riverside did not maintain proper supporting documentation, such as receipts indicating what was purchased, or packing slips noting who received the items and confirming that the purchased items were received. Without such documentation, an expense was appropriately deemed inadequately documented by the audit team because the documentation maintained by Riverside did not indicate the business nature of the expense. In many cases the expense "invoice" furnished to us by Riverside during our audit was a facsimile statement sent from the vendor of the goods/services dated after our request was made, as opposed to being dated when the actual purchase was made. Also, contrary to what Riverside asserts in its response, photocopies of receipts are not adequate documentation, since they can be altered. The vast majority of the organizations audited by the OSA have been able to maintain sufficient original documentation for all of their purchases, and we see no reason why Riverside should not have been able to do the same. Further, contrary to what Riverside states in its response, AICPA standards require auditors to gather sufficient, competent evidential matter in the conduct of their audit work. According to generally accepted government auditing standards, which incorporate AICPA standards, "examination of original documents provides more competent evidence than do copies."

Moreover, we disagree with Riverside's contention that it would not be possible for Riverside to misallocate funds and still operate the agency at an efficient level. If an agency does not provide the type and level of services required under its contract, or has negotiated a contract price that exceeds its actual needs to provide the program services, then sufficient discretionary funds would be available. During our audit, we did not assess the level of services Riverside provided under its state contracts or the reasonableness of the funding provided to the agency as compared to similar agencies. However, we did identify that Riverside appeared to have sufficient discretionary funds available during our audit period. These funds were used for a variety of purposes, including tens of thousands in state funds to pay the insurance premiums for a former business partner of Riverside's Executive Director who was not even an employee of the agency (Audit Result No. 2), over $269,000 in funds to fund the agency's profit-sharing plan during fiscal years 2002 and 2003 (Audit Result No. 6), over $181,000 to provide unallowable staff bonuses and fringe benefits during fiscal years 2002 and 2003 (Audit Result No. 5), funds to provide personal loans totaling over $103,000 to Riverside's Executive Director (Audit Result No. 10), and purchasing various luxury items, such as over $12,400 for two Red Sox season

tickets, tenderloin steak, lobster tails, shrimp, and beer and wine purportedly for staff. These expenses do not appear to be indicative of an agency that is driven to keep its costs low.

In its response, Riverside provides explanations as to the nature of some of the expenses we deemed to be non-program-related in nature. However, as stated in our report, the documentation the agency was maintaining relative to these expenses do not support Riverside's assertion that these expenses were reasonable and program-related. In fact, it its response, Riverside admits that some of these expenses, (e.g., those it paid on behalf of IAL), were in fact non-Riverside expenses. Of particular concern is that, as stated in our report, during our audit we judgmentally selected four transactions, contacted the vendors who provided the goods or services, and reviewed other available documentation to confirm what was actually purchased by Riverside. Although we acknowledge that our sample size for this test was small, for all four of these transactions, we found that the invoice Riverside paid appeared to not accurately represent the goods and services actually purchased. In our opinion, this brings into question the validity of the other documentation Riverside was maintaining relative to the expenses it billed against its state contracts and demonstrates why we wanted to receive original supporting documentation, as opposed to copies, for the agency's expenses during the conduct of our audit field work.

In its response, Riverside contends that the Red Sox tickets it purchased were for weekend games attended by its clients. However, as stated in our report, the tickets in question were in the name of Riverside's Executive Director's business associate. Also, the agency did not have any records of who attended the games. Consequently, we appropriately question the reasonableness of these expenses, since there was no documentation that indicated that these tickets were used for program-related purposes. During our audit, we noted other sports-related events and other group activities (e.g., movies) that were charged by Riverside against its state contracts. For example, we noted instances in which program staff appeared to have taken students to local Lowell Lock Monster hockey games. Although in many cases the documentation relative to these events was incomplete, we did not question them as being non-program-related, because the documentation that the agency did maintain indicated that normally a large group attended these local events. As the Red Sox tickets in question were for two box seats, it does not seem reasonable that they could effectively be used for program purposes.

Regarding the specific comments Riverside made relative to the non-program-related expenses we identified, we offer the following comments:

- Riverside contends that the flowers that it purchased for the spouse and daughter of the agency's Executive Director were in fact both mistaken entries. However, we question how two separate and distinct transactions would both have been mistakenly recorded in the exact same manner ("decorations for the school"). Further, it should be noted that we identified a number of other such questionable flower purchases with no documentation to substantiate the business nature of these purchases.

- Regarding the magazine subscription, as stated in our report, there was no documentation to substantiate the business nature of this purchase. Also, in its response Riverside did not give us sufficient information, such as who was teaching this alleged business course, when it was taught, and who attended it, for us to fully consider this claim. However, it does not seem practical that one magazine would be sufficient enough to be used as materials for a class being taught to approximately 50 boys.

- Riverside did give us a copy of a catalogue that showed that the company did in fact sell car mats. However, the agency did not provide us with documentation showing that the company in question sold the battery chargers it said it purchased from this same vendor. Also, the cost of the car mats in the catalogue Riverside provided were around $100, whereas the total payment to this vendor was $783.95. Consequently, it was still not possible to reconcile the items Riverside claimed to have purchased with the actual payment to this vendor.

- Regarding the statements from Riverside employees, we did not have the opportunity to speak with agency staff regarding all of the issues detailed in this audit result, and therefore cannot confirm that the staff representations provided to us regarding these matters were accurate. However, regardless of these representations, as stated above, Riverside, as required by state regulations, should have ensured that it maintained the proper documentation relative to all of its purchases to demonstrate that its expenses were reasonable, allowable and allocable to its state contracts.

5. UNALLOWABLE EMPLOYEE BONUSES AND FRINGE BENEFITS TOTALING $181,901

We found that during the period June 1, 2001 through March 31, 2004, Riverside gave its employees bonuses totaling $227,930, of which $127,923 was billed to its state contracts. However, contrary to OSD guidelines, Riverside did not have an established, written employee morale, health, and welfare policy in place at the time it awarded these bonuses. Furthermore, contrary to OSD guidelines, Riverside did not obtain the required preapproval of its principal purchasing agency or OSD. Additionally, there was no evidence that Riverside's board was aware of or had approved these bonuses. Without an established, written employee morale, health, and welfare policy in place, the bonus expenses that Riverside billed against its state contracts during our audit period are nonreimbursable according to state regulations. Also, without such controls, there is inadequate assurance that Riverside awarded employee bonuses in a fair and equitable manner. In fact, we found that Riverside's Executive Director and his wife

received a significantly higher percentage of the total bonuses awarded by Riverside during our audit period (12% and 5% respectively, as opposed to approximately 1% for non-administrative staff members).

In addition, Riverside's policies and procedures allow its staff members to receive medical insurance coverage at no cost to the employees after they have been employed by Riverside as full-time staff members for 90 days. However, we found that Riverside allowed the son and daughter of its Executive Director to receive this medical insurance coverage commencing on the first day of their employment. Further, Riverside continued to provide these fringe benefits to the son of Riverside's Executive Director for up to three months after he terminated his employment from Riverside. The cost of these fringe benefits provided to these individuals outside of Riverside's established policies and procedures totaled $7,116, of which $3,604 was charged by Riverside against its state contracts. According to state regulations, fringe benefits such as these that are not made available to all staff under an established policy of the agency are unallowable and nonreimbursable under state contracts.

In addition, we found that although Riverside did not have any formal written policies or procedures that provided for members of its staff to be reimbursed for tuition or training expenses, during the period of our audit, Riverside charged a total of $50,771 in such expenses against its state contracts. Of particular concern is that Riverside routinely paid for the full cost of staff members' tuition costs prior to their attending the course or training. In addition, Riverside did not require staff members to provide any documentation to substantiate that they had completed or even attended the course or training for which they were reimbursed. According to state regulations, fringe benefits such as these that are not made available to all staff under an established policy of the agency are unallowable and nonreimbursable under state contracts. The specific problems we identified in this area are discussed in detail in the following sections.

a. Unallowable Employee Bonuses Totaling $127,923

During the period June 1, 2001 through March 31, 2004, Riverside's Executive Director provided members of Riverside's staff with bonuses totaling $227,930, of which $127,923 was charged against Riverside's state contracts, as indicated in the table below:

Fiscal Year	Bonus Amounts	State of MA	MA cities/towns	State of NH	Adjustment*
2002	$110,060	$66,036	$34,119	$11,006	($1,101)
2003	58,838	29,419	21,182	8,237	-
2004 (through 3/31/04)	59,032	32,468	13,577	12,987	-
Totals	$227,930	$127,923	$68,878	$32,230	($1,101)

*Since Riverside commingled all its revenues, amounts in the table were calculated based on the percentage of each revenue category (e.g., state of MA), to total agency revenue. During fiscal year 2002, the agency incurred an investment loss so an adjustment was added to the table to reflect this decrease in total revenue to the agency.

In August 1997, OSD provided the following guidance concerning staff bonuses and fringe benefits:

> *Bonuses are not considered a fringe benefit; rather, they are properly classified as a salary allowance when attributable to services rendered by an employee. Bonuses are a negotiable item, which are added to salaries in the budget and in the financial statements. The net salary amounts must not exceed what is considered reasonable compensation to be reimbursable. There are two ways to furnish bonuses to employees: one is a fixed bonus as part of an employee's salary based on terms incorporated into his or her written employment agreement, and the second is through a Contractor's written employee morale, health and welfare policy, which makes available bonuses to all employees based on exceptional employee performance. See section 162 of the Internal Revenue Code and 808 CMR 1.05(20) for further guidance.*
>
> *A Contractor's employee, morale, health and welfare policy is also frequently confused with and inappropriately budgeted and/or reported as fringe benefits. Costs associated with the Contractor's employee, morale, health and welfare policy are not budgeted and/or reported on the UFR separately, as fringe benefits, but rather under Administrative Support, Direct Care or Occupancy costs, as applicable. However, unlike fringe benefits, the Contractor's employee morale, health and welfare policy may exclude members of management from benefiting or participating in the employee morale, health and welfare activities of the Contractor. Bonuses that are provided to management in addition to a fixed bonus awarded pursuant to the terms of an employment agreement and not as part of a Board approved employee morale, health and welfare plan are not reimbursable. Further information concerning the reimbursement of employee morale, health and welfare activities is available in the DPS publication "Additional Questions and Answers on Audit and Preparation of the UFR for Contractors and Their Independent Auditors" issued May 1995, and in OMB Circular A-122.*

During our audit, we determined that, contrary to OSD guidelines, Riverside did not have an established, written employee morale, health, and welfare policy in place at the time it awarded these bonuses. Furthermore, contrary to OSD guidelines, Riverside did not obtain the pre-approval of its principal purchasing agency or OSD. Without an established, written employee morale, health, and welfare policy in place, the $127,923 in bonus expenses that Riverside billed against its state contracts during our audit period are nonreimbursable. We

also reviewed the minutes of the meetings of Riverside's Board of Directors and did not identify any records indicating that Riverside's board was aware of or had approved these bonuses.

OSD has established guidelines for the proper reporting of nonreimbursable costs by human services providers such as Riverside. Specifically, OSD's Uniform Financial Statements and Independent Auditors' Report (UFR) Audit and Preparation Manual states, in part:

> *The existence of non-reimbursable costs, as contained in 808 CMR 1.05 (Effective 2/1/97, 808 CMR 1.05) and OMB Circulars A-21 and A-122, must be itemized by natural classification and disclosed in the component and program as applicable. Non-reimbursable costs that exist and have not been disclosed are presumed to have been defrayed using Commonwealth and Federal funds....*
>
> *This information, taken together with the auditor's compliance testing of non-reimbursable costs, provides UFR report users with a measure of assurance that all non-reimbursable costs have been defrayed with revenues not derived from public funds or designated by donors for other purposes.*

However, we determined that Riverside did not properly report these costs as nonreimbursable expenses on its fiscal year 2002 and 2003 UFRs that it filed with OSD.

Given Riverside's lack of controls over the administration and payment of staff bonuses, we analyzed how these bonus payments were distributed to agency staff. The table below summarizes the bonuses given to Riverside staff by fiscal year:

Position	6/1/01 – 6/30/02	Percent of Total Bonuses	Fiscal Year 2003	Percent of Total Bonuses	Fiscal Year to Date 2004	Percent of Total Bonuses	Total all Fiscal Years	Percent of Total Bonuses All Fiscal Years
Executive Director	$22,096	20%	$1,015	1%	$4,059	7%	$27,170	12%
Bookkeeper	10,000	9%	0	0%	2,166	4%	12,166	5%
Program Director	4,331	4%	4,331	7%	0	0%	8,662	4%
Education Director	5,414	5%	4,331	7%	2,166	4%	11,911	5%
Clinical Director	4,873	4%	2,166	4%	0	0%	7,039	3%
Program Director	0	0	0	0	3,249	6%	3,249	1%
Residential Director	3,790	3%	4,331	7%	2,166	4%	10,287	5%
Clinical Manager to Clinical Dir.	3,465	3%	4,331	7%	2,166	4%	9,962	4.5%
Maintenance Supervisor	3,219	3%	1,083	2%	1,083	2%	5,385	2.5%
Residential Manager	2,166	2%	1,299	2%	1,083	2%	4,548	2%
Residential Manager	2,707	2%	2,166	4%	1,624	3%	6,497	3%
Residential Manager	0	0	0	0	1,624	3%	1,624	1%
Other positions = 57,47,and 60, respectively	47,999	45%	33,785	59%	37,646	61%	119,430	52%*
Totals	$110,060	100%	$58,838	100%	$59,032	100%	$227,930	100%

* The average bonus percentage received by these non-management positions for each period was .8%, 1%, and 1%, respectively.

Riverside's Executive Director stated that Riverside does not have any written policies or procedures relative to the awarding of bonuses. He added that he determines the amounts to be given to each employee based on their salary and years of service with Riverside. However, the Executive Director could not provide us with any documentation for any fiscal year that demonstrated how he determined the percentage of bonuses to give to each staff member. The lack of controls over the awarding of these bonuses creates a situation in which there is inadequate assurance that bonuses are distributed in a fair and equitable manner. In fact, as noted in the table above, Riverside's Executive Director and his wife received the highest percentage of total bonuses paid by Riverside during our audit period.

Riverside's Executive Director stated that bonuses are available to all employees who had been employed for more than one year. The Executive Director added that his staff works hard and that he feels that it is appropriate to award bonuses when funds are available. Regarding the principal purchasing agency (PPA) being aware of the bonuses, he indicated that he did not directly communicate to Riverside's PPA that they were disbursed, but these amounts were incorporated in the payroll expenses and reported in Riverside's UFRs.

b. Nonreimbursable Fringe Benefit Expenses Totaling $3,604

The 808 CMR 1.05 promulgated by OSD identifies the following as nonreimbursable costs:

> *(9) Certain Fringe Benefits:(a) Fringe benefits determined to be excessive in light of salary levels and benefits of other comparable Contractors and fringe benefits to the extent that they are not available to all employees under an established policy of the Contractor…*

During our audit, we found that Riverside paid for 100% of the cost of medical and dental insurance for the all of its full time employees after they had been employed by Riverside for a specified period of time. Specifically, Riverside's Personnel Policies Manual states that Riverside will pay "100% of medical and dental insurance for all full-time employees after 90 days of active employment." During our audit period, we noted that the Executive Director's son was employed by Riverside during our audit period; however, he was not classified as a full-time employee, but rather as a temporary seasonal employee. According to agency records, this individual was hired in May 2002; however, his health insurance enrollment form indicated his employment start date was March 1, 2002. Riverside's Executive Director stated that his son terminated his employment with Riverside in December 2003. Because the Executive Director's son was not a full-time employee of Riverside, according to Riverside's policies and procedures he was not entitled to receive any dental and health insurance benefits. Despite this fact, we found that Riverside paid premiums totaling $6,353 to provide these benefits to this individual from the first date of his employment until up to three months after he terminated his employment with Riverside, of which Riverside charged $3,223 to its state contracts. We also found that Riverside paid the dental and health insurance premiums for the daughter of Riverside's Executive Director from the first date of her employment, rather than waiting for the 90-day period required by Riverside's policies. The premiums paid by Riverside for this individual during this period totaled $763, of which $381 was charged by Riverside against its state contracts.

Since the $3,604 in premium expenses that were charged by Riverside against its state contracts for these two individuals were not in accordance with the formal written policies and procedures of Riverside, they represent nonreimbursable costs under Riverside's state contracts in accordance with 808 CMR 1.05(a).

Regarding this matter, Riverside's Executive Director indicated that his son and daughter were former employees of Riverside, and therefore the 90-day waiting period did not apply to them. However, the Executive Director did not give us any documentation to substantiate this assertion.

c. Unreasonable and Unallowable Tuition Expenses Totaling at Least $50,374

During our audit period, Riverside did not have any formal written policies and procedures that provided for its staff to be reimbursed for tuition expenses. Nevertheless, we found that Riverside paid staff tuition expenses totaling at least $90,235, of which $50,374 was charged against its state contracts. Consequently, the $50,374 in expenses that Riverside charged against its state contracts to provide this fringe benefit to certain members of its staff represent unallowable costs in accordance with 808 CMR 1.05(9). Of particular concern is that Riverside routinely paid for the full cost of staff members' tuition costs prior to their ever attending the course or training. In addition, Riverside did not require staff members to provide any documentation to substantiate that they had completed or even attended the course or training for which they were reimbursed.

Recommendation

Riverside's principal state purchasing agency, DSS, should recover from Riverside the $181,901 in unallowable bonus and fringe benefit expenses that Riverside charged against its state contracts during our audit period. In the future, if Riverside wants to provide bonuses to its staff members, it should establish a formal written employee morale, health, and welfare policy that is consistent with OSD guidelines and is approved by its Board of Directors. In addition, Riverside should notify its state purchasing agencies and OSD in advance of any such expenditures being made. Until such policies are established, Riverside should ensure that it properly discloses any salary bonuses and other fringe benefit expenses as nonreimbursable costs in its UFRs. Finally, Riverside should take measures to ensure that it adheres to its own policies and procedures regarding the provision of health and dental insurance coverage to staff members.

Auditee's Response

In response to this audit result, a law firm representing Riverside stated, in part:

As an initial matter, Riverside would like to point out that OSD has never rejected or taken exception to any UFR filed by the school, and it is explained throughout this Response why Riverside believes its UFR entries were proper. In some aspects, Riverside believes that this audit is holding Riverside to an excessively high standard of review. This is especially disconcerting considering what an exemplary and efficient program Riverside has run over the years.

Again, the auditors need to know that Riverside recognizes that it needs to put written policies and procedures in place, and it is in the process of doing so. Nonetheless, it is also important to recognize that the salaries that Riverside paid to its employees never exceeded OSD guidelines, including adjustments for bonuses. Moreover, excepting the lack of written policies, Riverside believes that in general it appropriately set and allocated fringe benefits to its personnel. This is an issue that will be taken up with and reviewed by Riverside's Board of Directors.

- *Regarding the Executive Director's son and daughter, this statement is inaccurate. Each employee had worked at the facility on a full-time, seasonal basis prior to becoming a full-time, regular employee. All periods of full-time work, including seasonal, are credited toward the 90-day period. It is erroneous to exclude "full-time seasonal" from the definition of "full-time,"....*

- *Riverside sent the employee COBRA notices during this time, but the employee did not respond. Riverside will seek reimbursement from the employee for any periods after which it should have discontinued paying health insurance benefits.*

- *Riverside will develop written policies for reimbursement of employee tuition. However, the auditor should know that all of the tuition payments were made in connection with the services the employees provided to the facility. Pre-enrollment, the Executive Director would meet with each staff member who desired additional schooling to discuss an appropriate course of study. The Executive Director was also in direct contact with each school after the staff member enrolled, and as an extra safeguard even arranged to make payments directly to the school on the student's behalf.*

- *The Executive Director often held back salary adjustments and bonuses to himself and Riverside's bookkeeper until he was certain the facility to* [sic] *afford to pay them. Indeed, the 6/1/01 – 6/30/02 bonus was intended to make up, in part, for a lack of raises or bonuses to the Executive Director and the bookkeeper for the prior three years. The bonuses paid to these two employees were significantly less in the following years, while the bonuses paid to other employees increased. . . .By FY 2004 the percentages of total bonus received had equalized, with the bookkeeper making the same percentage (5%) as two other employees, and these three earning just slightly more than two others (at 4.5% and 4%). Not surprisingly, as the person responsible for the overall day-to-day management and operation of Riverside, the Executive Director received a greater percentage of the overall bonus pool. However, it was not unreasonable compared to his overall compensation. Moreover, as determined by a "Compensation Review" commissioned by the Board of Directors and performed by an independent third party, the Executive Director's compensation*

for 1998-2003 was $368,500.00 less than the market compensation at the 75th percentile. Trended to 2004 (at a 4% increase), this totals $423,900.00.

Regarding the unreasonable and unallowable tuition expenses of $50,374 we cite in our report, Riverside stated "Riverside's Executive Director paid these moneys directly to the schools. There was no opportunity for a misappropriation of the funds." Riverside also provided statements from Riverside employees indicating that they had participated in the agency's tuition reimbursement program.

Auditor's Reply

It its response, Riverside states that it is concerned that we are holding the agency to an "excessively high standard of review." However, to the contrary, we are only holding Riverside to the same standards that are applicable to all human service providers who contract with Commonwelath agencies. The fact that OSD may have never rejected or taken exception to any UFR filed by Riverside is irrelevant to this issue. OSD evaluates each UFR for completeness but does not have the ability to assess the reasonableness and accuracy of all the information in the UFR without conducting audit field work. It is up to the agency to be aware of OSD's requirements and to properly classify and report all revenues and expenses in accordance with these requirements.

Our report does not state that the salary expenses Riverside charged to its state contracts for staff exceeded OSD guidelines. Rather, we correctly point out that we found that during the period June 1, 2001 through March 31, 2004, Riverside gave its employees bonuses totaling $227,930, of which $127,923 was billed to its state contracts. However, contrary to OSD guidelines, Riverside did not have an established, written employee morale, health, and welfare policy in place at the time it awarded these bonuses. Furthermore, contrary to OSD guidelines, Riverside did not obtain the pre-approval of its principal purchasing agency or OSD. Additionally, there was no evidence that Riverside's board was aware of or had approved these bonuses. Without an established, written employee morale, health, and welfare policy in place, the bonus expenses that Riverside billed against its state contracts during our audit period are nonreimbursable according to state regulations. Also, without such controls, there is inadequate assurance that Riverside awarded employee bonuses in a fair and equitable manner. In fact, we found that Riverside's Executive Director and his wife received a significantly higher percentage (12% and 5% respectively, as opposed to approximately 1% for non-administrative staff

members) of the total bonuses awarded by Riverside during our audit period. Also, there was no documentation on file (e.g., performance evaluations) to substantiate how these bonuses were determined.

Contrary to what Riverside states in its response, the benefits provided to the son and daughter of Riverside's Executive Director were not provided in accordance with the policies and procedures of the agency. Specifically, Riverside's policies and procedures allow its staff members to receive medical insurance coverage at no cost to the employees after they have been employed by Riverside as a full-time staff member for 90 days. However, we found that Riverside allowed the son and daughter of its Executive Director to receive this medical insurance coverage commencing on the first day of their employment. Further, Riverside continued to provide these fringe benefits to the son of Riverside's Executive Director for up to three months after he terminated his employment from Riverside. In its response, Riverside contends that the two individuals in question had been full-time seasonal employees prior to becoming full-time regular employees, and that this was credited to their full-time employment. However, the personnel records for these individuals did not reflect this fact. Further, Riverside's policies and procedures do not indicate that full-time seasonal work counts towards the 90-day waiting period prior to being eligible for the company benefits in question. Also, there were no procedures in place or records that indicated that Riverside kept track of each "seasonal employee's" accumulated full-time days of employment to determine when they would complete 90 full-time work days and be eligible for there benefits. Also, Riverside did not comment on why it continued to provide these benefits to the agency's Executive Director's son for up to three months after he terminated his employment, when this benefit was not offered to any other staff member.

In its response, Riverside contends that the agency's Executive Director meets with staff members who desire additional schooling to discuss an appropriate course of study and is also in direct contact with their schools. However, there was no documentation on file at Riverside during the conduct of our audit work to substantiate these claims. In addition, we found that although Riverside did not have any formal written policies or procedures that provided for members of its staff to be reimbursed for tuition or training expenses, during the period of our audit, Riverside charged a total of $50,374 in such expenses against its state contracts. Of particular concern is that Riverside routinely paid for the full cost of staff members' tuition costs

prior to their attending the course or training. In addition, Riverside did not require staff members to provide any documentation to substantiate that they had completed or even attended the course or training for which they were reimbursed. In its response, Riverside states that it will develop policies and procedures for reimbursement of employee tuition. We believe such measures are necessary.

Riverside is incorrect in assuming that a payment made directly to the school on behalf of an employee guarantees that the employee actually attends or passes the course for which the expenditure was intended. In fact, as noted in our report, Riverside did not require and did not receive/maintain documentation that any courses that the agency paid for were actually attended and passed by the employees who received these tuition reimbursement payments. Under Riverside's tuition reimbursement program, an employee could register, then drop out or just not pass a course. Riverside would have reimbursed the employee for the course without knowing that the employee had not completed the course. In fact, we noted tuition "reimbursements" were paid to some employees with the only support being a copy of a registration form with a copy of a credit card number supposedly being used. Clearly, such a system lacks the controls necessary to ensure that the agency's and the Commonwealth's assets are being properly safeguarded.

In its response, Riverside states that the bonuses provided to the agency's Executive Director and his wife were higher during the period covered by our audit to make up for the lack of bonuses provided to these individuals in prior years. Since we did not review the documentation the agency was maintaining relative to staff bonuses provided by Riverside to its staff for the periods both prior and subsequent to the period covered by our audit, we cannot comment on this assertion.

In its response, Riverside refers to a compensation review that was conducted by a consultant (Grant Thornton LLP) after the completion of our audit fieldwork. Riverside contends that this review shows that the Executive Director's bonus was not unreasonable compared to the total compensation provided to Executive Directors in similar organizations that are paid at the 75th percentile compensation level. However, the information the consultant used to perform this analysis was incomplete. Specifically, in its report, the consultant states that it used the compensation provided to Riverside's Executive Director as reported in the agency's tax returns (IRS Form 990), which showed that Riverside Executive Director's base pay was $128,000 in

calendar year 2004. In addition, the consultant noted that Riverside's Executive Director received additional compensation during calendar year 2003 of $48,800, and extrapolated this to be included in his calendar year 2004 compensation, which would gave the Executive Director a total compensation amount of $176,800. However, a significant amount of benefits that the agency's Executive Director received was not disclosed in these filings. Based on agency records, the total compensation including benefits the Riverside's Executive Director received during calendar year 2004 was approximately $254,901, as follows:

Compensation/Fringe Benefit Description	Amount	Comments
Base pay	$128,181*	
Bonus	4,059	
Profit Sharing	40,000	
Life Insurance	30,000	
Vehicle Expenses**	19,661	
Tax Payments	$33,000	See Audit Result No. 1 for a description of this benefit.
Total	$254,901	

* Projected based on compensation levels being paid during the time of audit

** Since the agency did not maintain records of the business versus the personal use of the Executive Director's vehicle, (see Audit Result No. 9), it was not possible to determine how much of this amount was a benefit versus being business-related.

The consultant's report does not cite a total compensation figure for 2004, but for 2003, when the total compensation received by Executive Directors of similar organizations who were in the 75th percentile of compensation was $198,400. Projecting this information forward to 2004 (increasing it by 4%, which is the percentage the consultant uses in its trend analysis) would yield a total compensation amount of approximately $206,336 for the 75th percentile. As can be seen from our table above, during calendar year 2004 Riverside's Executive Director's total compensation, despite what the agency contends in its response, was significantly (24%) higher ($254,901-$206,336/$206,336) than even the 75th percentile calculated by the consultant. It is also important to point out that the consultant's report states that "The most common comparator is the 50th percentile" which is the average level of compensation as opposed to the 75th percentile Riverside uses in its response. Obviously, if we compare Riverside's Executive Director's total compensation for calendar year 2004 to the average compensation level (50th percentile) as detailed in the consultant review ($159,120 projected), it is clear that the Executive Director appears to be receiving total compensation far in excess of the average person in a similar position and organization.

Finally, it is important to note our concern with the lack of controls over the awarding of staff bonuses within the agency. Without such controls (e.g., formal written policies and procedures), the process for awarding staff bonuses is subject to abuse, and any bonuses that are not awarded under an established policy of the agency, approved by its board and state-purchasing agency, are nonreimbursable under state contracts.

6. UNALLOWABLE PROFIT-SHARING PAYMENTS TO RIVERSIDE'S EXECUTIVE DIRECTOR TOTALING AS MUCH AS $46,917 WERE TEN TIMES THE FACILITY AVERAGE AND EXCEEDED THE FRINGE BENEFIT RATE APPROVED BY DOE

During the period covered by our audit, Riverside used $173,440 in state funds to fund what it called a "profit-sharing" plan for members of its staff. Our review of the expenses associated with this plan indicated that the benefits under this plan were provided in a discriminatory manner. Riverside's Executive Director received over 28% of the total profit-sharing distributions issued during our audit period, or more than 10 times greater than the amount that the average staff person received in plan distributions during this period. We also found that the profit-sharing plan distributions Riverside's Executive Director received were unreasonable in that they exceeded the fringe benefit rate approved by DOE for Riverside during the period of our audit. According to state regulations, fringe benefits such as these that are unreasonable or provided in a discriminatory manner are nonreimbursable expenses under state contracts.

OSD, the state agency responsible for regulating and overseeing the activities of contracted human service providers such as Riverside, has promulgated regulations that identify specific costs that are unallowable and nonreimbursable under state contracts. In this regard, 808 CMR 1.05(9), promulgated by OSD, identifies the following as being nonreimbursable costs.

> *Certain Fringe Benefits. Fringe benefits determined to be excessive in light of salary levels and benefits of other comparable Contractors and fringe benefits to the extent that they are not available to all employees under an established policy of the Contractor....*

The intent of this regulation is to ensure that fringe benefits are distributed to staff in a non-discriminatory manner and that a vendor's state funding agencies are aware of and approve of a vendor's fringe benefits prior to being charged against state contracts.

In addition, OSD regulations define reimbursable operating costs under state contracts as follows:

> *Reimbursable Operating Costs. Those costs reasonably incurred in providing the services described in the contract and/or, in the case of a Program approved under the provisions of M.G.L. c. 71B, in providing the services mandated by DOE or specifically included in an Authorized Price, with the exception of costs enumerated in 808 CMR 1.05 and costs excluded in the Authorized Price. Operating costs shall be considered "reasonably incurred" …only if they are reasonable and allocable using the standards contained in Federal Office of Management and Budget Circular A-122 or A-21, or successors thereto.*

According to OMB Circular A-122:

> *(1) Costs of the organization's pension plan which are incurred in accordance with the established policies of the organization are allowable, provided:*
>
> *(a) Such policies meet the test of reasonableness;*
>
> *(b) The methods of cost allocation are not discriminatory…*

The test of reasonableness as detailed in OMB Circular A-122 is in part, as follows:

> *Reasonable costs. A cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the costs. … In determining the reasonableness of a given cost, consideration shall be given to:*
>
> *Whether the cost is of a type generally recognized as ordinary and necessary for the operation of the organization or the performance of the award.*
>
> *The restraints or requirements imposed by such factors as generally accepted sound business practices, arms length bargaining, Federal and State laws and regulations, and terms and conditions of the award.*
>
> *Whether the individuals concerned acted with prudence in the circumstances, considering their responsibilities to the organization, its members, employees, and clients, the public at large, and the Federal Government…*

During our audit, we reviewed Riverside's financial records, as well as the UFRs that it filed with OSD, and noted that although Riverside was incorporated and was functioning as a nonprofit organization, it was using state funds to fund what it called profit-sharing accounts for members of its staff. During our audit, we asked Riverside officials to provide us with all the information (e.g., written policies and procedures) on how it determines how much money is paid each year for profit sharing and how much money Riverside staff members receive in their accounts. In response, agency officials provided us with a copy of a document entitled, "Plan Specifications New England Human Services Inc. Profit Sharing Plan & Trust For The Plan Year January 1, 2002 through December 31, 2003." According to this document, the plan was set up as a staff retirement plan to supplement Social Security, has been in effect since January 1, 1995, and is fully funded by Riverside. The Plan Administrator is Riverside, and the Plan's Trustee listed in

these documents is Riverside's Executive Director. In order to be eligible for this profit-sharing program, staff members must be at least 21 years of age and vest in this program over a five-year period, as follows:

Years of Service	1	2	3	4	5
Percent*	20	40	60	80	100

* This is the percentage employees receive upon leaving service. For example, if an employee had $3,000 credited into her profit-sharing account and left during year 1, she would receive only $600 ($3,000 X 20%). The remaining balance $2,400 gets redistributed to existing plan participants based on their distribution percentages.

During the period covered by our audit, Riverside incurred a total of $311,143 in profit-sharing expenses, of which it billed $173,440 to its state contracts. The balance of $137,703 was billed by Riverside to Massachusetts cities and towns and the State of New Hampshire, as indicated in the table below:

Summary of Profit-Sharing Expenses

Fiscal Years 2002 Through 2004 (March 31,2004)

Fiscal Year	Expensed Amount	Percent Billed to State Contracts	Amount Billed to State Contracts	Amount Billed to MA Cities & Towns	Amount Billed to New Hampshire	Other Funding (offsets)
2002	$ 157,910	.60	$ 94,746	$ 48,952	$15,791	($1,579)
2003	111,678	.50	55,839	40,204	15,635	0
2004	41,555	.55	22,855	9,558	9,142	0
Totals	$ 311,143		$ 173,440	$ 98,714	$ 40,568	($1,579)

Our first concern with this plan is that there are no formal written policies and procedures over the process of determining how much money is available to fund this profit-sharing program. Specifically, there are no predetermined contribution amounts established. Rather, Riverside's Executive Director stated that at the end of each fiscal year, he determines the amount of excess revenues over expenses that Riverside has available and then arbitrarily determines how much to make available to fund the plan. Once this has been determined, Riverside sends these funds to the Winchester Benefit Group (WBG) of Stoneham, which manages this plan. Although we do not dispute that it is not uncommon to have an agency fund a retirement plan for its staff, the type of system Riverside has established creates an incentive for Riverside to cut costs so that more funds are available to distribute in Riverside's profit-sharing plan, which could potentially jeopardize the quality of services in its programs.

Our second concern is that, contrary to OSD regulations, Riverside's profit-sharing plan distributes compensation in a discriminatory manner. Specifically, there are two classes of plan participants. Class A consists solely of Riverside's Executive Director, who is entitled to receive up to 100% of his compensation, up to a maximum of $40,000 per year. In contrast, the participants in Class B of the plan, which is everyone else employed by Riverside, are entitled to receive 6.5% of their total compensation, up to $40,000. This disparity in benefits has resulted in the Executive Director receiving a significantly disproportionate amount of all profit-sharing contributions: $88,195, or 28% of the $311,143 in profit-sharing distributions made by Riverside of which $46,917 was charged to state contracts during our audit period.

In addition to the fact that Riverside's Executive Director received his profit sharing compensation in a discriminatory manner, the profit-sharing funds provided to Riverside's Executive Director is unreasonable for two reasons. First, Special Education Schools such as Riverside are reimbursed under their state contracts at what is called a Special Education Authorized Price (SEAP), which is established based on budgeted expenses that Riverside submitted to DOE for approval. Once approved, OSD establishes the SEAP. Under its current SEAP, Riverside stated that its fringe benefit rate would be 13.21%. However, the amount of distributions that the Executive Director received under Riverside's profit-sharing plan alone put his fringe benefit rate significantly over the approved 13.21% rate. For example, during fiscal year 2003, the $40,000 that Riverside contributed to its Executive Director's profit sharing account alone represents a 33% fringe benefit, as shown below.

Fiscal Year	Salary	Profit Sharing	% Fringe To Profit Sharing Contribution	Percent Over 13.21%
2002*	$118,590	$8,195	6.91%**	N/A
2003	$120,015	$40,000	33.33%	20.12%
2004**	$128,181	$40,000	31.2%	17.99%

* The separate Class A for the Executive Director was not established until 2003, hence the lower contribution amount.

** This amount is projected, since Riverside's audited UFR for fiscal year 2004 was not available as of the end of or audit field work.

As can be seen from the table above, once Riverside's Executive Director placed himself in a separate class (Class A) from all of Riverside's other employees, his profit-sharing contributions alone during fiscal years 2003 and 2004 represented a 33.33% and 31.2% fringe benefit, respectively. In contrast, the average staff person in Class B received a fringe benefit that represented 6.523% of their total compensation, as shown in the table below for fiscal year 2003:

Employee	Employee Compensation	Profit Sharing Amount	Percentage of Profit Sharing to Compensation
Executive Director	$120,015	$40,000	33.33%
Employee 1	$ 58,935	$ 3,845	6.52%
Employee 2	$ 56,712	$ 3,700	6.52%
Employee 3	$ 39,805	$ 2,597	6.52%

Also, we do not believe that providing a $40,000 profit-sharing payment to Riverside's Executive Director was prudent, given that according to Riverside's Executive Director, Riverside had to borrow $50,000 from Fleet Bank during fiscal year 2003 to meet its cash flow needs. (See Audit Result No. 10.)

Finally, it should also be noted that the minutes of the meetings of Riverside's Board of Directors do not indicate that Riverside's board was aware of and had approved the use of these funds in this manner.

Regarding this matter, Riverside's Executive Director stated that he believes that the contributions made by Riverside on his behalf were appropriate and that this benefit is beneficial to the program in that it helps to limit staff turnover.

Recommendation

In order to address our concerns relative to this matter, we recommend that OSD, in conjunction with DSS, review this matter and determine what portion of the $46,917 in profit sharing expenses that Riverside charged against its state contracts for its Executive Director should be recovered. In the future, if Riverside wants to fund a retirement program other than Social Security for members of its staff, it should take measures to ensure that it establishes adequate controls over the administration of such a plan, and that plan benefits are clearly defined, budgeted, and distributed in a fair and equitable manner, consistent with state and federal requirements.

Auditee's Response

In response to this audit result, a law firm representing Riverside stated, in part:

> *This plan and its methods of allocation have been approved by the Internal Revenue Service and are in compliance with the ERISA regulations. An independent, third-party administrator (Lafayette Insurance Company) manages the assets of the plan, verifies the propriety of the annual Riverside contributions, and prepares the allocation of the contributions to the participants. The two-tiered plan contributions are consistent with methods that many entities use to provide additional incentives in their attempt retain key employees. Riverside is in the process of developing written policies and procedures regarding its plan. It will seek its Board of Directors and DSS's review of the same.*
>
> - *Since the Tax Reform Act of 1986, Congress has recognized that a non-profit organization may offer what is known as a "profit-sharing" plan to its employees. A non-profit is held to the same requirements as a for-profit regarding the reasonableness of such plans, but any suggestion that this plan is questionable or impermissible simply because Riverside is an IRS 501(c)(3) exempt organization is incorrect.*
> - *This is an inaccurate oversimplification of the method for determining contributions to the plan. Moreover, contributions to the plan must meet IRS guidelines regarding non-discriminatory distribution among employees. The plan, and contributions to the plan, are overseen by an independent third-party administrator, Lafayette Insurance Company. Consequently, Riverside's Executive Director cannot make "arbitrary" decisions regarding the contributions.*
> - *There is a distinction between paying key employees what is necessary to retain their services in a competitive market, and debt financing. Many businesses continue to pay discretionary fringe benefits (i.e., bonuses) while they are borrowing to cover costs. Indeed, the fact that the pension plan was funded at a time when the facility needed to borrow funds to meet its cash flow needs is further evidence that this was not truly a "profit-sharing" plan, but a pension plan that is funded on a regular basis.*

Auditor's Reply

Our report does not take issue with the fact that Riverside has established a profit-sharing plan for its staff. In fact, our report even describes it as a retirement plan the agency has established to supplement each employee's Social Security retirement benefits. Our concern is with the inadequate controls over the plan. In its response, Riverside states that the IRS has approved all the provisions of this plan, that the plan is administered by an independent third party, and that therefore all contributions to the plan (even those for the agency's Executive Director) were appropriate. However, as stated in our report, our review of the expenses associated with this plan indicated that the benefits under this plan were provided in a discriminatory manner, in that Riverside's Executive Director received over 28% of the total profit-sharing distributions issued by Riverside during our audit period, or over 10 times greater than the amount that the average staff person received in plan contributions during this period. We also found that the profit-sharing plan contributions Riverside's Executive Director received under this plan were unreasonable in that they exceeded the fringe benefit rate approved by DOE for Riverside during the period of our audit. According to state regulations, fringe benefits such as the profit-sharing distributions provided to Riverside's Executive Director that are unreasonable or provided in a discriminatory manner are nonreimbursable expenses under state contracts. Consequently, even if this plan met certain IRS guidelines, some of the contributions made to the plan during the period covered by our review did not meet OSD's regulations relative to allowable expenses.

In its response, Riverside states that the plan is administered by an independent third party and meets all IRS requirements relative to plan contributions. However, as noted in our report, we determined based on our conversations with the agency's Executive Director that there are no formal written policies and procedures over the process of determining how much money is available to fund this profit-sharing program. Specifically, according to the documents we were provided and our discussions with Riverside's Executive Director, there are no predetermined contribution amounts established. Despite what Riverside states in its response, Riverside's Executive Director us told that at the end of each fiscal year, he determines the amount of excess revenues over expenses that Riverside has available and then arbitrarily determines how much to make available to fund the plan. Once this has been determined, Riverside sends these funds to the Winchester Benefit Group, which manages this plan. Also, as previously mentioned, contrary to OSD regulations, Riverside's profit-sharing plan distributes compensation in a discriminatory manner.

In addition to the fact that Riverside's Executive Director received his profit-sharing compensation in a discriminatory manner, we found the profit-sharing funds provided to Riverside's Executive Director to be unreasonable for two reasons. First, special education facilities such as Riverside are reimbursed under their state contracts at what is called a Special Education Authorized Price (SEAP), which is established based on budgeted expenses that Riverside submitted to DOE for approval. Once approved, OSD establishes the SEAP. Under its current SEAP, Riverside stated that its fringe benefit rate would be 13.21%. However, the amount of distributions that the Executive Director received under Riverside's profit-sharing plan alone put his fringe benefit rate significantly over this approved rate. For example, during fiscal year 2003 the $40,000 that Riverside contributed to its Executive Director's profit sharing account alone represents a 33% fringe benefit.

While we acknowledge that in some circumstances firms may need to borrow funds to fund pension plans, this is not a good business practice and, in the case of Riverside, was unnecessary. Since the amount contributed to the profit-sharing plan was not fixed and was determined by the agency's Executive Director, the agency had the ability to reduce the amount of contributions to the plan during periods of negative cash flow. Moreover, during this period of time, the agency paid approximately $168,000 in staff bonuses, which are clearly discretionary. If the agency had forgone these bonuses, it would have eliminated the need to borrow much of the $190,000, and at the same time could have essentially fully funded its profit-sharing plan.

While we do not object to a not-for-profit agency having a profit-sharing plan for its employees, we do believe that controls need to be established and in place to ensure that such a plan is properly funded and administered in a fair and equitable manner.

7. QUESTIONABLE COMPENSATION TOTALING $91,035 PROVIDED TO RIVERSIDE'S BOOKKEEPER, THE SPOUSE OF RIVERSIDE'S EXECUTIVE DIRECTOR

We found that during the period July 1, 2001 through June 30, 2004, Riverside paid the spouse of its Executive Director a total of $184,453 in compensation to function as Riverside's Bookkeeper, of which $91,035 was charged by Riverside against its state contracts. During our audit, we reviewed this individual's personnel file and spoke with her regarding her job-related duties and responsibilities, and identified several problems. First, her personnel file did not contain information to justify her hiring or how her rate of compensation was established, a job description detailing her duties and responsibilities, or any job performance evaluations.

According to this individual's resume, she did not have any formal training or work experience in the area of accounting or bookkeeping. Also, during fiscal years 2003 and 2004, this individual received pay increases totaling almost 20% of her current salary, in addition to a $10,000 bonus during fiscal year 2002 and a $2,160 bonus during fiscal year 2004 without any written evaluations or other documentation on file at Riverside to document why she was entitled to receive these significant pay increases. Moreover, during our audit period, Riverside paid accounting consultants and an auditing firm a total of $131,294 to provide various accounting and auditing-related duties. The services these consultants provided included preparation of all internal adjusting entries to Riverside's general ledger; preparation of all invoices, and recordkeeping of all revenue and accounts receivables. According to the Bookkeeper, she worked out of her home, and her primary duties were to make out checks at the direction of the Executive Director and to perform other minor recordkeeping activities. Consequently, we question the reasonableness of providing this level of compensation for the limited services provided by this individual.

The 808 CMR 1.05, promulgated by OSD, identifies the following as a nonreimbursable cost to state-funded contracts:

> *(1)Unreasonable Costs. Any costs not determined to be Reimbursable Operating Costs as defined in 808 CMR 1.02 or any amount paid for goods or services which is greater than either the market price or the amount paid by comparable Departments or other governmental units within or outside of the Commonwealth.*

Further, OMB Circular A-122, Attachment A-General Principles Section, with which Riverside must comply, states the following:

> *Reasonable costs. A cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the costs. The question of the reasonableness of specific costs must be scrutinized with particular care in connection with organizations or separate divisions thereof, which receive the preponderance of their support from awards made by Federal agencies. In determining the reasonableness of a given cost, consideration shall be given to:*
>
> - *Whether the cost is of a type generally recognized as ordinary and necessary for the operation of the organization or the performance of the award.*
> - *The restraints or requirements imposed by such factors as generally accepted sound business practices, arms length bargaining, Federal and State laws and regulations, and terms and conditions of the award.*

- *Whether the individuals concerned acted with prudence in the circumstances, considering their responsibilities to the organization, its members, employees, and clients, the public at large, and the Government....*

We found that the spouse of Riverside's Executive Director has been employed as Riverside's Bookkeeper since Riverside's inception. During our audit, we reviewed this individual's personnel file and spoke with her regarding her job-related responsibilities. Based on our review, we noted the following issues:

- The Bookkeeper's personnel file did not contain documentation to justify her hiring, how her rate of compensation was established, or any job description that detailed her job related responsibilities. Rather, her personnel file contained only her resume and a copy of her driver's license. Since the Bookkeeper did not have a formal written job description, during our audit we interviewed her regarding her job duties and responsibilities. This individual stated that she works at her house in Lynnfield and that her duties include paying the invoices that her husband, Riverside's Executive Director, tells her to pay; posting payment transactions to Riverside's general ledger; and reconciling Riverside's bank statements. However, during our audit we found no evidence that the Bookkeeper actually prepared reconciliations of Riverside's monthly bank statements. In fact, we reconciled six of Riverside's banks statements and found numerous discrepancies, indicating that an effective reconciliation process was not being performed by Riverside. We also noted a number of problems with the transactions being recorded in Riverside's General Ledger. For example, none of the adjusting entries on the General Ledgers maintained by Riverside during our audit period had any supporting documentation for the adjustments that were made, or indicated whether Riverside officials had approved the adjustments. We also noted numerous mistakes in Riverside's General Ledgers. For example, in fiscal year 2004, a check dated August 2, 2003 was cashed on July 31, 2003, two days before it was issued. In addition, we noted that a check for $10,500 was issued to Midway Motors on July 24, 2002, according to Riverside's General Ledger. However, our review of the check indicated that it was actually issued to Riverside's Executive Director. We also noted that Riverside did not maintain its voided checks.

- The Bookkeeper's resume showed that her background experience included teaching school for five years prior to being hired as Riverside's Bookkeeper. However, it did not indicate that she had any formal training or work experience in the fields of accounting or bookkeeping.

- During the period July 1, 2001 through March 31, 2004, Riverside paid three consultants and an audit firm $131,294 to perform a variety of accounting/bookkeeping functions, such as making internal adjusting entries to Riverside's General Ledger, preparing Riverside's UFRs and supporting schedules, issuing invoices, and maintaining accounts receivable and revenue information. Moreover, Riverside's private auditing firm handles the recording of Riverside's accounts payable, the calculation of its depreciation expenses, and the allocation of its indirect administrative expenses. Consequently, the services performed by Riverside's Bookkeeper appeared to be very limited.

- During the period covered by our review, the Bookkeeper received significant increases in her compensation, as indicated in the following table:

Fiscal Year	Salary	Increase	Increase %	Bonus	Profit Sharing	Total Compensation	Total Charged to State Contracts**
2002	$49,725	Prior to Audit period *	-	$10,000	$2,318	$62,043	$29,835
2003	56,400	$6,675	13.42%	0	3,845	60,245	28,200
2004	60,000	$3,600	6.38%	2,165	0	62,165	33,000
Total	$166,125			$12,165	$6,163	$184,453	$91,035

* This information was obtained from the company that manages Riverside's payroll service and records. .

We noted that the Bookkeeper's bonus of $10,000 in fiscal year 2002 was significantly higher than the amount received by similar-salaried employees and was the second highest bonus given to any agency staff person with the exception of her husband, the Executive Director, who received $22,096 during that fiscal year. The next highest bonuses given by Riverside during that fiscal year were to its Education Director, who received $5,414, and its Clinical Director, who received $4,873. However, Riverside did not have any documentation (e.g., annual evaluations or records of board votes) that documented why this individual was entitled to these significant increases in compensation with no apparent increase in her job-related responsibilities.

Regarding this matter, Riverside's Executive Director stated that Riverside has been trying to keep its administrative costs low by employing only one full-time person and hiring consultants as needed to perform accounting-related activities. However, given that Riverside's Bookkeeper has limited job-related responsibilities and that there is no documentation to substantiate how her compensation level was established or why she was given the significant pay increases she received, the compensation provided to this individual is unreasonable in that it does not represent ordinary and necessary costs that should have been incurred by Riverside. Hence, this compensation is unallowable in accordance with state regulations.

Recommendation

In order to address our concerns relative to this matter, we recommend that OSD, in conjunction with DSS, review this matter and recover from Riverside and its Executive Director, that portion of the $91,035 in unreasonable salary expenses it charged against its state contracts

for compensation provided to its Bookkeeper that they deem appropriate. Furthermore, DSS, in conjunction with OSD, should conduct its own review of Bookkeeper salary costs charged by Riverside against its state contracts during the four fiscal years prior to those covered by our audit. Based on this review, the agencies should take any additional measures they deem appropriate to resolve this matter.

Auditee's Response

In response to this audit result, a law firm respecting Riverside stated, in part:

> *It is not uncommon to operate an office out of one's home, and to hire a spouse or family member to work therefrom. As the Commonwealth's auditors know, space at the Riverside School is at a premium. In order to use as much school space for programs, the Executive Director created separate office space at his residence (at his own expense). All of the bookkeeping functions are performed at the residence. It is also important to note that the Executive Director could have charged Riverside for the use of the office space at a rate of at least $1,000.00 per month. During the audit period, these costs would have totalled $33,000.00, and over the past twenty-five years would have equalled $300,000.00. . . .*
>
> *Moreover, because of the office location and the hours involved (some work is done in the evening and some on the weekend) it is very convenient that the bookkeeping function be performed by someone with 24-hour access to the bookkeeping office. Indeed, if this work were perfomed at Riverside, the facility would have incurred significant overtime costs for travel to Riverside when work was performed on nights and weekends.*
>
> *The bookkeeper has been employed by Riverside since its inception. Clearly, over that time this employee has gained valuable, on-the-job skills. Industry-specific experience can often compensate for lack of formal, if generalized, training. Moreover, her education and experience as a teacher was useful in this school environment. . . .*
>
> *This employee's total compensation was within the OSD guidelines.*
>
> *Accuracy of work performed by an agency employee is not a valid audit standard. It is probably safe to say that the auditors could evaluate <u>any</u> employee's job performance at <u>any</u> agency over a three-year period and find instances where the employee made a mistake. Would this be cause to find such employee's entire compensation "unreasonable"? If so, no agency could ever treat an employee's salary as a legitimate expense.*
>
> *The school used three different outside consultants during the audit period. These functions are generally beyond the scope of services of an internal bookkeeper. Moreover, they add an important check-and-balance to Riverside's accounting process – they should be viewed as a positive, not as a justification for attacking the internal bookkeeper. Indeed, if this were a larger company, the consultants simply would have come in-house as employees, <u>in addition to</u> the bookkeeper. Use of consultants does not mean, as implied, that the bookkeeper is not qualified. Moreover, this use of consultants was cost-effective, as the work performed by the consultants could not support a full-time employee and could be more efficiently managed through sporadic, temporary*

consultant services. By using consultants, Riverside also saved the expense of fringe benefits that an employee would have received.

A - Billing service - All attendance and tuition deposits are done internally. The billing service takes the internally-generated information and prepares monthly invoices and statements of balances due from the various cites, towns and agencies. Billing can usually be done more efficiently by a department or company that is dedicated to billing and collections functions and can utilize economies of scale. Outsourcing the billing function is a cost-saving measure, especially as the billing service provides collection services as well.

B - OSD consultant - Riverside employs an expert to semi-annually review its general ledger and make adjustments. This consultant was formerly associated with a firm that specialized in the audit of 766 schools and is currently involved with a large 766 program. This is a check-and-balance by an independent third party. Rather than utilize is as a negative against the facility's bookkeeper, the auditors should appreciate that Riverside engages in such a review.

C - UFR consultant - Riverside had on retainer an individual whose responsibility was to review the school's compliance with the various UFR regulations. This consultant is a former employee of the Commonwealth of Massachusetts Rate Setting Commission and at the Commonwealth was responsible for reviewing various UFR submissions. Once again, this should be viewed as a positive check-and-balance, rather than used as a club against Riverside's bookkeeper.

Finally, the current audit firm is engaged to perform the audit for several 766 schools. It is not unusual for the audit firm to maintain the depreciation records, and prepare many adjusting entries. Once again, this is not a reflection on the competency of the bookkeeper.

Indeed, if this were a larger company, the consultants simply would have come in-house as employees, in addition to the bookkeeper. Use of consultants does not mean, as implied, that the bookkeeper is not qualified. Moreover, this use of consultants was cost-effective, as the work performed by the consultants could not support a full-time employee and could be more efficiently managed through sporadic, temporary consultant services. By using consultants, Riverside also saved the expense of fringe benefits that an employee would have received.

Finally, it is not logical to conclude that this employee's entire compensation is unallowable, as the report itself indicates that the bookkeeper provided services and value to Riverside. Moreover, the report does not include any objective measure to determine what portion of the bookkeeper's compensation the auditors deemed unreasonable.

Regarding the bonus received during our audit period, Riverside indicated, "From 2000 – 2004, the compensation to Riverside's bookkeeper increased an average of only 4%-5%. The bonus in 2002 was designed as an adjustment for a lack of raises and bonuses to the bookkeeper over the prior 3 or more years."

Auditor's Reply

We agree with Riverside that it is not unusual for a company to hire related individuals or in some instances to allow employees, where permissible, to work part time out of their home. However, given the size of Riverside's operation (approximately $4 million per year in state revenue) and the fact that Riverside appeared to be renting ample space from its related party to house at least one more person, we do not believe it was necessary or proper for this individual to work out of her home. This is of particular importance given the fact that the bookkeeper's supervisor was her husband, and given the lack of internal controls over the agency's activities as detailed throughout our report, they together had total control over the agency's transactions, including their authorization, payment, and recording. Given this poor control environment, we believe it would have been more appropriate to maintain the agency's records on site at Riverside's place of business. This would have given the appearance that agency records were being properly safeguarded at the agency's place of business, and would have facilitated more complete and expeditious reviews by oversight agencies. As noted in the Background section of this report, because the agency was maintaining its records at the home of its Executive Director, records were not readily available for our review, which delayed our audit process and limited our ability to conduct all of the audit testing we deemed necessary to meet some of our audit objectives.

We disagree with Riverside's contention its Executive Director could have charged the Commonwealth $1,000 per month for the use of the office space in his home that he used for Riverside related activities. All contracted human service providers, including Riverside, are provided with sufficient funding from their state purchasing agencies to lease the space necessary to house both their programmatic and administrative activities. Consequently, any additional charges for office space in the personal home of the agency's Executive Director would be considered unreasonable and therefore unallowable in accordance with OSD regulation 808 CMR 1.05(1). Although home office expenses may be an allowable deduction on the Executive Director's personal income tax return, they would not be a reimbursable expense under Riverside's state contracts. Also, we cannot comment on Riverside's assertion that some of the agency's work is done during the evenings and on weekends, since the bookkeeping work was done offsite.

We acknowledge that Riverside's bookkeeper has been employed by the agency since its inception. We also acknowledge that work experience is important in developing job related

skills. However, as stated in our report, the bookkeeper's personnel file did not indicate that she had any formal training or work experience in the fields of accounting or bookkeeping when she was hired in her current position. Since there was no one on staff to train the bookkeeper, we question the extent to which she could have improved her job-related skills. In fact, during our interviews with her, she indicated that she did not know what internal controls were, and appeared to lack the knowledge necessary to ensure that there were adequate controls over the agency's accounting process. Her inability to adequately perform all the duties and responsibilities of her position is further evidenced by the fact that she was not maintaining adequate documentation to support all of the agency's expenses.

As noted in our report, the Bookkeeper's personnel file did not contain documentation to justify her hiring, how her rate of compensation was established, or any job description that detailed her job related responsibilities. Given the relationship between the bookkeeper and her supervisor, (her husband), and her lack of formal training and job experience in the area of bookkeeping, it is essential that Riverside evaluate the job performance of this individual and formally document these evaluations in the individual's personnel file. Such documentation would serve to demonstrate her competency in performing her job-related responsibilities, and would add integrity to Riverside's staff compensation process by providing documentation that she was entitled to her salary, pay increases and bonuses and that such increases were not due to nepotism. However, Riverside did not have any documentation (e.g., annual evaluations or records of board votes) that documented why this individual was entitled to the significant increases in compensation she received during our audit period with no apparent increase in her job-related responsibilities.

Our report details how Riverside used consultants to perform functions, such as billings, that are normally provided by agency accounting/bookkeeping staff. In presenting this information, our intention was not to question the integrity of the bookkeeper, but rather to detail the fact that the activities being performed by the bookkeeper by her own admission were limited to certain tasks.

We did not attempt to determine what portion of the bookkeeper's compensation was allowable because the documentation being maintained by the agency, as well as our interviews with staff, did not allow us to be able to make this determination. For example, the time sheets we received were not approved by an independent party, but were in fact signed by her husband. Also,

Riverside's Executive Director, and not the bookkeeper, signed the majority of the checks we reviewed. Without job descriptions, periodic evaluations, and other records that indicated the tasks the bookkeeper was performing, it was not possible to determine how much of her compensation was reasonable and allowable. Although we do not dispute that the bookkeeper did perform some agency related activities, as discussed in this report, we found problems with many of the agency's accounting records relative to these activities.

8. HIGHLY QUESTIONABLE AND UNALLOWABLE CREDIT CARD EXPENSES TOTALING AT LEAST $50,472 CHARGED TO STATE CONTRACTS

During the period July 1, 2001 through March 31, 2004, Riverside reimbursed its Executive Director and its bookkeeper $90,325, of which $50,472 was allocated to its state-funded contracts, purportedly for agency expenses charged on their personal credit cards. However, we found that Riverside had not established internal controls relative to the reimbursement of personal credit card expenses. We noted significant problems with the documentation Riverside was maintaining relative to the 529 expenditures totaling $90,325 that were charged on these personal credit cards during our audit period. First, none of the 529 expenses were adequately documented. Also, $84,280 of these expenses were questionable in that they did not appear to be related to the social service program purposes of Riverside's state-funded programs, including $944 for banquet gifts/sports memorabilia; $1,070 for two snowboards; and $356 for a bicycle and helmet. We also identified 113 expenditures totaling $23,458 (of which $13,165 was charged to state contracts) in which the voucher documentation used by the Executive Director to request reimbursement for the expense differed from what was indicated on the credit card statement. For example, Riverside paid a vendor $460 for what Riverside's records indicated was first aid boxes and various medical supplies. However, the credit card statement indicated that this purchase was for vitamin bars. According to state regulations, expenses that are inadequately documented or not directly related to the program activities of service providers are nonreimbursable under state contracts.

OSD has promulgated regulations that define certain costs that are unallowable and nonreimbursable under state contracts. Specifically, 808 CMR 1.05(12), and 808 CMR 1.05(26), promulgated by OSD, defines the following as being nonreimbursable program costs:

> *Section 1.05(12) Non-Program Expenses: Expenses of the contractor, which are not directly related to the social service program purposes of the contractor.*

Section 1.05(26) Undocumented Expenses: Costs, which are not adequately documented in the light of the American Institute of Certified Public Accountants statements on auditing standards for evidential matters.

During the period July 1, 2000 through March 31, 2004, Riverside reimbursed its Executive Director and its Bookkeeper $90,325 for agency expenses that they claimed to have incurred on their personal credit cards, as indicated in the following table:

Fiscal Year	Staff Person's Title	Credit Card Type	Amount
2002	Executive Director	American Express	$34,919
2002	Bookkeeper	Chase Visa	6,760
2003	Executive Director	American Express	19,324
2003	Bookkeeper	Chase Visa	6,490
2004 (through 3/31/04)	Executive Director	American Express	13,540
2004 (through 3/31/04)	Bookkeeper	Chase Visa	9,292
			$90,325

Our audit revealed that Riverside had not established any internal controls over the use of these personal credit cards. Specifically, we found that Riverside's Executive Director and the Bookkeeper routinely used personal credit cards to pay for what they claimed were program-related purchases without any oversight or independent approval process. Also, there were no written procedures that require individuals who use their personal credit cards to pay for agency expenses to document the date, place, amount, and nature of each expense, or to submit original receipts to substantiate the reasonableness and appropriateness of these expenditures. Finally, no member of Riverside's administrative staff performs an independent review of these expenses to determine their propriety and allocability to state contracts.

Based on these internal control deficiencies, we reviewed the documentation maintained by Riverside relative to all of the 529 expenditures totaling $90,325 made by the Executive Director and his wife that were paid for by Riverside, of which $50,472 was charged against its state-funded contracts during the period July 1, 2001 through March 31, 2004. Based on our review, we identified numerous problems with these expenses. Specifically, many were non-program-related, and all of them lacked adequate supporting documentation. Moreover, we found that the items recorded by Riverside as being purchased differed from the items recorded on Riverside's credit card statements. The table below summarizes the results of our review in this area.

Riverside

Summary of Questionable Credit Card Expenses

Fiscal Years 2002 through 2004 (March 31,2004)

Fiscal Years	Inadequately Documented	Non-Program-Related	Expenses with Documentation Discrepancies
2002	$41,679	$40,351	$12,571
2003	25,814	25,170	7,303
2004 through 3/31/2004	22,832	18,758	3,584
Totals	$90,325	$84,279	$23,458

Included in the $90,325 of total expenses that were not adequately documented was $84,279 in expenditures that did not appear to be related to the social service purposes of Riverside's state-funded programs and therefore should not have been charged against Riverside's state contracts. Examples of those non-program-related expenses include the following:

- On August 4, 2003, Riverside paid $944 for banquet gifts/sports memorabilia from Jacksonville Golf & Learn of Jacksonville, Florida.

- On November 6, 2002, Riverside paid $1,070 for two snowboards from the Golf and Ski Warehouse in Greenland, New Hampshire.

- On March 5, 2003, Riverside paid $356 for a bicycle and a helmet at L.L. Bean in Freeport, Maine.

- On March 21, 2003, Riverside paid the Golf Club Haus in Layton, Utah $1,042 for three snowboards, six pairs of ice skates, and two sets of boots. According to Riverside's Residential Director, Riverside does not purchase skiing, snowboarding, or ice skating equipment for students in the program because program staff are not necessarily trained in skiing and skating and therefore do not take students on such trips.

- On February 21, 2002 Riverside paid $1,145 to the Golf and Ski Warehouse in New Hampshire for ski poles and equipment.

- On December 15, 2003, Riverside paid $402 to Wine Country Gift Baskets, purportedly for Christmas gifts for board members. However, during our audit we spoke with a member of Riverside's board about this expense, and this individual stated that board members never received a gift of merchandise from this vendor.

- On July 6, 2002, Riverside paid $194 to the Hardcover Restaurant in Danvers, Massachusetts, purportedly for board meeting dinner expenses. However, there was no record as to what agency business was discussed at this board meeting. Moreover, a member of Riverside's board stated that he never went to this restaurant for a board meeting.

We also found 113 instances totaling $23,458, of which $13,165 was charged to Riverside's state-funded contracts, where the items purchased per Riverside's credit card statement were different than what Riverside claimed was purchased according to its payment voucher form that details the location (vendor), purpose, and amount of each expense. Examples of these discrepancies follow:

- On February 15, 2003, Riverside paid two expenses totaling $750 to PayPal for what was identified as "housekeeping" on the credit card statement, and as "school software and video games" on Riverside's voucher form.

- On November 12, 2003, Riverside paid Davidson Chevrolet in Malden, Massachusetts, $1,000 for a miscellaneous charge according to Riverside's credit card statement, but the voucher indicated that it was a deposit for the purchase of a truck. On May 28, 2004 Riverside's Executive Director claimed that this charge was for repairs to an agency vehicle. However, on June 1, 2004, he stated that this expense was for the purchase of a truck for himself.

- On March 5, 2002, Riverside paid RB Products of Phoenix, Arizona $456. According to Riverside's voucher form, this payment this was for first aid boxes and various medical supplies. However, the credit card statement indicated that the payment was for vitamin bars.

- On June 24, 2002, Riverside paid $1,159.50 to Lowes in Danvers, Massachusetts for railings for Riverside's 258 Varnum Street residence, according to what Riverside staff wrote on the credit card statement. However, on the voucher used to request reimbursement to the credit card company, the Executive Director indicated it was for railings/decks for porches at Riverside's Berry Road location.

- On August 5, 2003, Riverside paid the Sheraton Ferncroft Hotel in Danvers, Massachusetts $386 for lodging, according to the credit card statement. However, Riverside's voucher form for this expense indicated that it the expense was for a board dinner meeting.

- On June 23, 2003, Riverside paid the Harbor View Motel in Edgartown, Massachusetts $795 for a board dinner according to a notation written by Riverside staff on the credit card statement. However, Riverside's voucher for this expense indicated that it was deposit for a retreat by some of Riverside's staff.

Regarding these matters, Riverside's Executive Director stated that using his and his wife's personal credit cards was the best and most convenient way to make these purchases. He indicated that, in his opinion, these were all reasonable expenses and that he was unaware that additional documentation should have been maintained to support them.

Recommendation

In order to address our concerns relative to this matter, we recommend that DSS recover from Riverside the $50,472 in inadequately documented, non-program-related and highly questionable credit card expenses that it charged against its state contracts during the period covered by our audit. Further, DSS, in conjunction with OSD, should conduct its own review of the credit card reimbursements charged by Riverside against its state contracts during the four fiscal years prior to those covered by our audit. Based on this review, DSS should recover from Riverside any funds it deems appropriate. Finally, Riverside should immediately establish and implement effective internal controls over the use of credit cards by staff members. At a minimum, these controls should require staff members who use corporate credit cards for business expenses to obtain prior authorization for these expenditures and to maintain and submit to Riverside adequate documentation relative to their business purposes. The documentation relative to each expense should be independently reviewed and approved by members of Riverside's administrative staff prior to payment.

Auditee's Response

In response to this audit result, a law firm representing Riverside stated, in part:

> *The Executive Director used his personal credit cards to retain tighter control over their use. An employee would request authorization to make a purchase for the program and, if approved, the Executive Director would provide the employee with a credit card. The employee would make the purchase, and the Executive Director would keep track of what was purchased by the employee on an on-going basis (the employees would retain the receipts in the respective facility or department). When the credit card invoice would arrive, the Executive Director or bookkeeper would reconcile the list with the invoice.*
>
> *Sometimes, in the transfer from list or invoice to ledger, the information may have been incorrectly identified by accident. For example, a purchase of railings for use at one of the four Riverside buildings was mistakenly recorded as having been used at a different Riverside building. While technically an incorrect accounting entry, there is no doubt that the railings were used by a Riverside facility, and thus an allowable program expense. Nonetheless, Riverside recognizes that it must revisit and modernize its tracking of such expenses. Such use will be reviewed by the Board of Directors, and internal controls will be established for future program use. . . .*
>
> *However, items identified as "questionable" expenses by the auditors - such as snowboards, skis, skates, and bicycles - were routinely purchased for use by the students in the program. In fact, as the auditors inventoried such items during their on-site visit, it is unclear why they would be deemed "unallowable."*
>
> *As explained above, Riverside's system may have caused some entries to be less accurate than Riverside would have preferred, but that does not mean that the items*

expensed were not put to program use. Riverside is concerned that form is being unfairly emphasized over substance. There is no evidence that "inadequately documented" or "highly questionable" credit card expenses were non-program related. Consequently, it is an overstatement to suggest that all credit card expenses are not allowable.

Riverside provided the following comments for the specific expenditures we questoned in our report:

- *[$460 for "first aid boxes and medical supplies" but credit card statement states "vitamin bars"] These are accounting entry errors which do not render the items unallowable. Riverside recognizes that it has an obligation to be reasonably accurate when accounting for program expenses, but whether these items were recorded as first aid for the students or vitamin bars for the students, the fact remains that the purchased items were used by the students and were, consequently, a permitted program expense.*

- *[$944 for banquet gifts/sports memorabilia] Each year Riverside conducted an awards banquet for the students. Parents, DSS workers, foster parents, siblings, etc. were invited and attended. Students received awards at the ceremony, including a variety of sporting goods and items such as books, pictures, autographs, hats, etc.*

- *[$1,070 for two snowboards; $356 for one bicycle and helmet; $1,042 for three snowboards, six pairs of ice skates and two sets of boots; $1,145 for ski poles and equipment] As noted, previously, as part of the program students at Riverside are taken snowboarding, skiing, bicycling, hiking, etc. The auditors were shown where the inventory of equipment for such use is maintained on-site, and were even provided with an inventory list of such equipment. Following the audit, the Executive Director spoke with the Residential Director (actually, the "Program Director"), who informed the Executive Director that he did not make such a comment to the auditors, or that there was a miscommunication between himself and the auditors. As the Program Director was recently hired at the time of the audit, it is possible that the new Program Director was not familiar with all of Riverside's winter activities at that time. Riverside obtained a Statement from its former Program Director, however, which confirms that Riverside students did engage in activities such as skiing.*

- *[$402 for gift baskets] The Wine Country Gift Baskets were holiday thank-you's to the Board members. All Board members received them. Riverside spoke with this particular Board member, who explained that when the auditors asked whether he received any "gifts" from NEHS, he thought they meant monetary gifts or special favors. He said that he completely forgot about the once-a-year holiday gift baskets. Riverside can only surmise that the Board member may have misunderstood the question.*

- *[$194 for dinner at the Hardcover Restaurant in Danvers, MA] Once again, Riverside is unsure why any Board member would make such a statement, and can only surmise that the Board member may have misunderstood the question or did not attend this particular meeting. The meeting was held to discuss the Riverside program.*

- *[$750 shown as "housekeeping"] Riverside cannot be held responsible for the way that PayPal reports purchases. Paypal is a payment service for transactions over the*

internet, most often through eBay. It should be obvious that Riverside was not purchasing "housekeeping" over the internet.

- *[$1,000 to Davidson Chevrolet] The deposit was for the purchase of a truck, but the transaction was never completed. The deposit was returned and recorded, to the best of Riverside's knowledge, as miscellaneous income.*

- *[$456 paid and noted as first aid boxes and various medical equipment, but statement states it was for vitamin bars] The purchase was for vitamin bars and other medical/nutritional supplies used by the students. It was program-related, and therefore not unallowable.*

- *[$1,159.50 to Lowes for railings] While not a perfect accounting entry, a simple view of the premises would have made evident that the materials were used by Riverside at one of its facilities. The auditors must keep in mind that the students at Riverside are very strong and active – sometimes violent and destructive. Building fixtures that normally have five to ten year useful lives often wear out, break down, or are broken in half that time. Consequently, the amount and frequency of building supply, furniture and carpet purchases are much higher than in other types of state agency programs. Moreover, they are clearly program-related, and therefore not "highly questionable."*

- *[$386 for lodgings] Once again, Riverside cannot be held responsible for the description a business uses what it posts credit card entries. The payment was for a meal during a Board meeting. In fact, Riverside contacted the Sheraton Hotel, and asked a representative of its account receivables department how meals at the Hotel appear on credit card invoices. Riverside was informed that all meals are billed as "lodging" by the credit card companies because it is a hotel.*

- *[$795 for a board dinner] Riverside recognizes that it is expected to be more accurate in its accounting, and it will do so. Nonetheless, this again is an example of form over substance. Whether a board dinner meeting or staff retreat, it is an allowable program expense.*

Riverside intends to implement tighter controls regarding its credit card expenses. However, as pointed out previously the Executive Director did implement an authorization system by requiring employees to obtain his approval to use the credit cards. Employees will be instructed on adequate documentation.

Auditor's Reply

Contrary to Riverside's response, the mere fact that the agency's Executive Director and his wife, the agency's Bookkeeper, used personal credit cards to make the purchases in question, does not effect better controls over the purchases made with these cards. In fact, as stated in our report, our audit revealed that Riverside had not established any internal controls over the use of these personal credit cards. Specifically, we found that Riverside's Executive Director and the Bookkeeper routinely used personal credit cards to pay for what they claimed were program-related purchases without any oversight or independent approval process. Also, there were no written procedures that require individuals who use their personal credit cards to pay for agency

expenses to document the date, place, amount, and nature of each expense or to submit original receipts to substantiate the reasonableness and appropriateness of these expenditures. Finally, no member of Riverside's administrative staff performs an independent review of these expenses to determine their propriety and allocability to state contracts. Although, in its response, Riverside describes a process whereby the agency's Executive Director tightly controlled and monitored all purchases made with these cards, this was not the process described to us during our audit, and did not appear to be the process being followed by the agency based on our audit testing. In fact, during our audit we met with the Executive Director on numerous occasions concerning these expenditures, and at no time did he mention or describe the credit card authorization process the agency describes in its response.

In its response, Riverside concedes that the agency may have made some errors in the recording of expenses and states that it will take measures to address this problem. We believe such measures are necessary given that, as stated in our report, we found 113 instances in which the items purchased did not match the information in the agency's records. Clearly, program expenditures cannot be deemed allowable and allocable to the state unless they are adequately documented with supporting records and approvals.

As stated in our report, we found a number of times in which Riverside paid for various items with state funds that appeared to be non-programmatic and questionable in nature. We do not doubt that the program does purchase some items to be used by the students for recreational activities. However, as stated in our report, according to Riverside's Residential Director, Riverside does not purchase downhill skiing, snowboarding, or ice skating equipment for students in the program, because program staff are not necessarily trained in skiing and skating and therefore do not take students on such trips. Despite this, we found a number of instances in which such equipment was paid for by Riverside. These purchases seemed unusual, given the statements made by the Residential Director and the fact that on certain occasions, the equipment was purchased out-of-state and was only usually enough for two people (e.g., two snowboards in Greenland N.H. and a bicycle in Freeport Maine), as opposed to being sufficient enough to conduct a group activity for up to 50 boys. Further, contrary to what Riverside states in its response, we did not take an inventory of all the sports equipment Riverside was maintaining. During our audit, we did visit all of Riverside's program sites. During these site visits, Riverside's Executive Director did point out to us some bicycles and skates; however, we

did not observe any snowboards or skis. Further, during our site visits, Riverside's Executive Director told us that these bikes and skates were a combination of client-owned, donated by previous clients, and/or purchased with state or out-of-state tuition funds, as opposed to being purchased exclusively with Massachusetts state funds. Riverside did provide us with an inventory listing, but this listing was undated and lacked any identifying information (e.g., identification tags) for us to have conducted inventory testing as Riverside inaccurately claims in its response. This inventory listing did list skiing and other sports equipment, but did not identify their dates of purchase or what funds were used to purchase the items. Therefore, it was not possible to match the invoices in question with this inventory listing to determine whether the sports items purchased were in fact being utilized in Riverside's programs. Further, the agency's inventory did not identify any snowboards being used in its programs, even though we identified snowboards being purchased during our audit testing.

In its response, Riverside gives specific explanations as to why the expenses we questioned were allowable. However, as noted in our report, Riverside is obligated by state regulations and the terms and conditions of its state contracts to ensure that it adequately documents all of its expenses. The agency is provided with sufficient funds necessary under its state contracts to properly maintain its records. Without such documentation, the Commonwealth cannot be assured that expenses in question are reasonable, allowable, and therefore allocable to state contracts.

9. UNALLOWABLE AND QUESTIONABLE VEHICLE EXPENSES TOTALING $51,556

We found that during the period July 1, 2001 through March 31, 2004, Riverside charged vehicle expenses totaling $117,451 against its state contracts, including $31,619 in expenses relative to a vehicle used by Riverside's Executive Director. However, Riverside's policies and procedures do not provide for the provision of this fringe benefit to this individual. According to state regulations, fringe benefits such as these that are not provided under an established policy of the agency are unallowable and nonreimbursable under state contracts. We also found inadequately documented and questionable expenses totaling $25,510 associated with Riverside's other vehicles, including $7,214 in gasoline charges that appeared to have been incurred by IAL, Riverside's related party organization, and $5,250 for the purchase of a Jeep Wrangler, whose business purpose Riverside could not document. According to state regulations, inadequately

documented and non-program-related expenses such as these are unallowable costs under Riverside's state contracts.

During our audit period, Riverside leased/owned the following vehicles:

Vehicle Type	Purported Use	Lease/Own
2000 Jeep Cherokee	Administrative – Executive Director	Leased – Turned in on June 7, 2002, not replaced
2002 Audi all-road	Administrative – Executive Director	Leased – Replaced with Volvo
2004 Volvo S60 Sedan	Administrative – Executive Director	Leased
1999 Ford Econovan –12 passenger	Program	Leased
2001 Ford Econovan –12 passenger	Program	Leased
2001 Ford Econovan – 12 passenger	Program	Leased
2001 Dodge Minivan – 7 passenger	Program	Leased
Canoe Trailer	Program	Own
1998 Jeep Wrangler	Maintenance	Own (sold 12/03)

During this same period, we found that Riverside incurred the following expenses associated with the operation of these vehicles:

Administrative (Executive Director) Vehicle Costs

Fiscal Year	Vehicle Costs	Insurance Costs	Gas Costs	Total Costs	Nonreimbursable to State of MA	MA Cities/Towns	State of NH	Other
2002	$14,044	$3,437	$3,567	$21,048	$12,629	$6,525	$2,104	($210)
2003	11,122	2,381	2,849	16,352	8,176	5,887	2,289	0
2004 through 3/31/04	9,895	5,706	4,060	19,661	10,814	4,522	4,325	0
Totals	$35,061	$11,524	$10,476	$57,061	$31,619	$16,934	$8,718	($210)

Program Vehicle Costs

Fiscal Year	Lease/Insurance Costs	Gas Costs	Total Costs	Non-reimbursable State of MA	Cities /Towns	State of NH	Other
2002	$50,959	$10,572	$61,531	$36,918	$19,075	$6,153	($615)
2003	40,718	13,383	54,101	27,051	19,477	7,574	0
2004 through	30,295	9,456	39,751	21,863	9,143	8,745	0

3/31/04							
Totals	$121,972	$33,411	$155,383	$85,832	$47,695	$22,472	($615)

A total of $31,619 in vehicle expenses charged by Riverside against its state contracts during our audit period was associated with vehicles provided by Riverside as a fringe benefit to its Executive Director. In this regard, 808 CMR 1.05, promulgated by OSD, identifies the following as nonreimbursable costs under state contracts:

> *(9) Certain Fringe Benefits.*
>
> *(a) Fringe benefits determined to be excessive in light of salary levels and benefits of other comparable Contractors and fringe benefits to the extent that they are not available to all employees under an established policy of the Contractor. Disparities in benefits among employees attributable to length of service, collective bargaining agreements or regular hours of employment shall not result in the exclusion of such costs.*

During our audit, we noted that Riverside's policies and procedures do not provide for the Executive Director to be provided with this fringe benefit, and Riverside's Executive Director did not have an employment contract that provided for this benefit. Consequently, the $31,619 in expenses that Riverside charged against its state contracts to provide this fringe benefit to its Executive Director are unallowable and nonreimbursable in accordance with OSD regulations.

We also found that Riverside has not established adequate controls over these vehicle expenses. Specifically, Riverside does not have any policies and procedures that require agency staff to maintain vehicle logs regarding their business use versus personal use. Further, the Executive Director indicated to us that Riverside has between five and eight gasoline credit cards "floating around," but that he does not know who has possession of them. The Executive Director added that Riverside does not require the business purpose of each vehicle expenditure to be documented.

OSD has promulgated regulations that define certain costs that are unallowable and nonreimbursable under state contracts. Specifically, 808 CMR 1.05(12) and 808 CMR 1.05(26), promulgated by OSD, define the following as being nonreimbursable program costs:

> *Section 1.05(12) Non-Program Expenses: Expenses of the contractor, which are not directly related to the social service program purposes of the contractor.*
>
> *Section 1.05(26) Undocumented Expenses: Costs, which are not adequately documented in the light of the American Institute of Certified Public Accountants statements on auditing standards for evidential matters.*

During our audit, we reviewed a judgmental sample of vehicle expenses, including gasoline credit card, insurance, and leasing invoices, which totaled $48,432 or 23% of the total $212,444 in vehicle expenses incurred by Riverside during our audit period. We noted questionable and inadequately documented costs totaling $25,510, of which $14,687 was charged by Riverside against its state contracts. An example of these questionable costs includes seven Sunoco gas card statements totaling $7,214, dated February 24, 2004, that encompassed various purchases of gasoline during our audit period. These statements were facsimile copies, and were issued to "Institute at Lowell 34 Berry Road", rather than to Riverside, but were paid by Riverside. Since $14,687 of the vehicle-related expenses that we reviewed were inadequately documented and/or did not appear to be related to the social service program purposes of Riverside's state-funded programs, they are unallowable in accordance with OSD regulations.

In addition to the questionable vehicle operating expenses discussed above, we also noted questionable circumstances relative to the 1998 Jeep Wrangler purchased by Riverside for $10,500, of which $5,250 was charged by Riverside against its state contracts, as follows:

- Riverside's General Ledger indicates that check No. 9902 dated July 24, 2002 (fiscal year 2003) was issued to Midway Motors for $10,500, but the canceled check was issued to and signed by Riverside's Executive Director.

- The calendar year 2003 and 2004 excise tax bills for this vehicle were paid to the Town of Lynnfield, where the Executive Director lives, although Riverside has no programs there.

- Riverside officials claimed that they used this vehicle for plowing, but we noted that Riverside incurred plowing expenses totaling $8,410 ($5,770 in fiscal year 2003 and $2,640 in fiscal year 2004) for outside plowing services.

- On July 1, 2004, when questioned about the status of the Jeep Wrangler, the Executive Director claimed that it had been sold in early January 2004 and that the proceeds from the sale were deposited into Riverside's accounts. However, he was unable to provide us with any documentation to substantiate these claims.

Given that Riverside could not demonstrate that this vehicle was used for its state-funded program purposes or provide us with documentation to substantiate that the proceeds from the sale of this vehicle were deposited in Riverside's accounts, the $5,250 that Riverside charged against its state contracts for the purchase of this vehicle represent nonreimbursable costs in accordance with state regulations.

Regarding these matters, the Executive Director indicated that these vehicle expenditures were necessary and reasonable and that the Jeep had been used for Riverside business purposes. However, he was not able to provide us with any documentation (e.g., vehicle usage logs), to substantiate these claims.

Recommendation

In order to address our concerns relative to this matter, we recommend that DSS recover from Riverside the $51,556 in unallowable vehicle expenses Riverside charged against its state contracts during the period covered by our audit. Further, DSS, in conjunction with OSD, should conduct its own review of all the vehicle expenses charged by Riverside against its state contracts during the four fiscal years prior to our audit period. Based on this review, DSS should recover from Riverside any funds it deems appropriate. In the future, Riverside should implement adequate controls over all vehicle expenditures.

Auditee's Response

In response to this audit result, a law firm representing Riverside stated, in part:

> *This is also an area that Riverside recognizes that it needs to, and will, tighten. But the fact that the accounting system used by Riverside needs to be updated does not take away from the obvious fact that Riverside and its employees are putting these vehicles to program uses. . . .Riverside will address this policy with its Board of Directors. Suggesting that half the funds should be dis-allowed for such use is excessive, unreasonable, and illogical.*
>
> *This conclusion does not follow from the regulation. 808 CMR 1.05(9) provides for <u>two</u> distinct types of fringe benefits analysis: (i) Fringe benefits determined to be excessive in light of salary levels and benefits of other comparable Contractors; and (ii) fringe benefits to the extent that they are not available to all employees under an established policy of the Contractor. As a company vehicle is not a fringe benefit that would be "available to all employees," the second analysis – and the requirement for "an established policy" – is obviously inapplicable. Consequently, the analysis is under (i). As a key member of senior management, it is not unusual for the fringe benefit package of an executive director to include a company automobile. There is nothing to suggest that such a benefit is "excessive" in light of salary levels and benefits of other comparable Contractors, which is the standard of review. . . . . there is no evidence in compliance with 808 CMR 1.05(9) that this fringe benefit is excessive in light of salary levels and benefits of other comparable Contractors. Consequently, the Executive Director's use of the vehicles should be allowed.*
>
> *Regarding the gasoline charged to IAL credit cards, IAL was the former owner of Riverside (before NEHS incorporated as a non-profit and acquired the school from IAL). An old IAL credit card was still being used by Riverside. However, IAL does not own or utilize any vehicles (it is essentially a real estate holding company). All gasoline expenses were for Riverside vehicles.*

- *The gasoline cards remain in the name of the prior owner of the school, IAL, but are still used and paid for by Riverside. Moreover, IAL does not own any vehicles. All gasoline purchases under the IAL cards were for Riverside vehicles in connection with program uses.*

- *An automobile is often included in an executive's package, especially as the executive is required to travel among multiple sites, on nights and weekends, and for emergencies. Numerous state workers with less responsibility than the Executive Director have automobiles provided by the Commonwealth. Especially with Riverside's bookkeeping system, providing a vehicle was more efficient than trying to keep track of miles and submitting an expense mileage report.*

Regarding the 1998 Jeep Wrangler, Riverside provided the following comments:

- *The Jeep Wrangler, which Riverside acquired used, was purchased with the intent of adding a reliable 4-wheel drive vehicle for use by the staff, especially for travel from one facility to another during the winter. Riverside also planned to use the Wrangler to do some light plowing. Unfortunately, the vehicle was so unreliable it was sold a short time later.*

- *The day that Riverside's Executive Director went to purchase the Jeep, he asked the bookkeeper to issue him a blank check, and to mark it as payable to Midway Motors in the company ledger. Once he had the final purchase price from Midway Motors (taxes, fees, etc.), he would fill out the check and report the amount for entry in the ledger. However, Midway Motors informed him that they would not accept a company check. Consequently, the Executive Director made the check out to himself in the full amount of the purchase, and deposited it into his personal bank account, then drew from his personal account a cashier's check made payable to Midway Motors. The entry in Riverside's general ledger was never corrected.*

- *[The calendar year 2003 and 2004 excise tax bills] This was an error by the insurance company, which mistakenly registered the vehicle in Lynnfield. Nonetheless, the vehicle had been purchased by NEHS, and was registered under NEHS's name. In fact, it made no business sense to register the vehicle in Lynnfield. As a non-profit, Riverside could have avoided excise tax if the vehicle were registered in Lowell.*

- *The Executive Director purchased the vehicle from Riverside for more than Kelly Blue Book value, then traded the vehicle in on a purchase of a new personal automobile.*

- *Notwithstanding the lack of precise documentation, this is an unfair conclusion. As the Commonwealth well knows, being an Executive Director is a 24-hour, seven-day-a-week job. This is especially true where the school has a 365 day resident program, with special needs students who can and often do engage in significant behavioral problems at all hours of the day and night. The vehicle and its expenses are provided to the Executive Director for the convenience of his employer. There have been many nights and weekends when the Executive Director has been called to school to intervene in a problem.*

Auditor's Reply

We do not doubt that Riverside staff, to some extent, used the vehicles in question for program-related activities. Our concern is that, as stated in our report, Riverside has not established adequate controls over these vehicle expenses. Specifically, Riverside does not have any policies and procedures that require agency staff to maintain vehicle logs regarding their business use versus personal use. Further, the Executive Director indicated to us that Riverside has between five and eight gasoline credit cards "floating around," but that he does not know who has possession of them. Riverside's Executive Director told us that he does not even require that the business purpose of each vehicle expenditure be documented. Consequently, it cannot be determined the extent to which the vehicles in question were used for business-related activities. Our report does not state that half of the funds Riverside used to pay vehicle related expenses should be disallowed. As noted in this audit result, during the period covered by our audit, Riverside incurred $212,444 in vehicle related expenses; we are questioning $51,556.

Our report does not state that the vehicle provided to Riverside's Executive Director is unallowable because it is excessive. Rather, our report correctly points out that a total of $31,619 in vehicle expenses charged by Riverside against its state contracts during our audit period was associated with vehicles provided by Riverside as a fringe benefit to its Executive Director. In this regard, 808 CMR 1.05, promulgated by OSD, identifies the following as non-reimbursable costs under state contracts:

> *...fringe benefits to the extent that they are not available to all employees under an established policy of the Contractor....*

The operative wording in this regulation is that benefits should only be provided to staff members under established policies of the agency that are in writing and that have been reviewed and approved by the agency's Board of Directors and its principal state purchasing agency. This regulation is designed to prevent the Commonwealth from paying for benefits that are provided in a discriminatory manner. While we do not argue that the Executive Directors of some agencies are provided with a vehicle for business use, during our audit we noted that Riverside's policies and procedures do not provide for the Executive Director to be provided with this fringe benefit, and Riverside's Executive Director did not have an employment contract that provided for this benefit. Consequently, the $31,619 in expenses that Riverside charged against its state contracts to provide this fringe benefit to its Executive Director are unallowable and

nonreimbursable in accordance with OSD regulations. Further, according to Riverside's records, this additional fringe benefit was not reflected in the Executive Director's Form W-2.

In its response, Riverside contends that the $7,214 in gasoline charges were billed to IAL because Riverside was still using an old credit card issued to IAL. However, we question why Riverside would be using a credit card of another company that it has not, as an agency, been affiliated with for many years. Further, it is unreasonable and impractical for us to believe that an agency such as Riverside, which receives approximately $4 million in annual revenues, would not have its own credit cards to use for gasoline purchases, and would not have implemented better controls over the use of these cards. Riverside has not given us any documentation to date to refute the fact that the gas expenses as documented were for IAL.

In addition to the questionable vehicle operating expenses discussed above, we also noted questionable circumstances relative to the 1998 Jeep Wrangler purchased by Riverside. In its response, Riverside states that the agency's Executive Director made a check out to himself that he deposited in his account, and then wrote a check from his personal account to pay for the Jeep in question. However, the agency did not provide us with any documentation to substantiate this claim. We also find it unusual that the automobile dealership would not accept a corporate check, but would accept a personal check.

In its response, Riverside contends that its insurance company mistakenly registered the Jeep in Lynnfield instead of Lowell. However, we question how this could happen, since it is the owner of the vehicle who gives the insurance company the information it needs, including where the vehicle will be garaged.

Contrary to what Riverside states in its response, our conclusions are fair and based on our review of the agency's records. Riverside is required by state regulations and the terms and conditions of its state contracts to maintain its records to adequately document all of its expenses. Since in the instances noted in this audit result, the agency failed to do so, it was necessary and proper for us to question the propriety of these expenses.

10. QUESTIONABLE LOANS MADE BY, TO, AND FROM RIVERSIDE'S EXECUTIVE DIRECTOR, AND UNALLOWABLE INTEREST EXPENSES TOTALING $2,325, OF WHICH $1,279 WAS CHARGED TO STATE CONTRACTS

During our audit period Riverside's Executive Director used $103,805 that Riverside received under its state contracts to give himself three personal loans. However, there were no formal written agreements relative to these loans specifying the terms and conditions of repayment, and there was no documentation to substantiate that Riverside's board was aware of and had approved the use of agency funds for these purposes. According to state regulations, expenditures for such items as personal loans, which are not related to the social service program purposes of organizations, are unallowable and nonreimbursable under state contracts. We also found that during fiscal years 2002 and 2003, Riverside borrowed $190,000 ($40,000 from Riverside's Executive Director and $150,000 from Fleet Bank), purportedly to meet Riverside's cash flow needs. However, we question whether this was a prudent management decision, given that during these two fiscal years, Riverside expensed profit-sharing payments and staff bonuses totaling $438,486 which could have been used to pay agency expenses without borrowing any funds. Of particular concern is that Riverside did not have adequate documentation to substantiate that its Executive Director actually provided with the full amount of $40,000 that he claimed to have loaned Riverside. The specific issues we identified in these areas are discussed below.

a. Riverside's Executive Director Used Agency Funds to Provide Himself Loans Totaling $103,805

The 808 CMR 1.05, promulgated by OSD, identifies the following as nonreimbursable costs under state contracts:

> *(12) Non-Program Expenses. Expenses of the Contractor which are not directly related to the social service Program purposes of the Contractor.*

During our audit, we reviewed Riverside's financial records and noted that during our audit period Riverside made three personal loans to its Executive Director. The information on amounts, dates, and repayments relative to these loans, as indicated by Riverside's accounting records, are detailed in the following table:

Loan Date	Riverside Check Number	Loan Amount	Repayments	Date of Repayments	Interest Paid on Loan	Reason for Loan

Loan Date	Riverside Check Number	Loan Amount	Repayments	Date of Repayments	Interest Paid on Loan	Reason for Loan
9/10/03	11120	$40,000	$38,805	3/31/04	$ 0	Personal
11/9/03	11298	25,000				Personal
			50,000	4/5/04	250	
1/2/04	11472	38,805	15,000	4/27/04	0	Personal
Totals		$103,805	$103,805		$250	

During our audit, we asked Riverside officials to provide us with all of the documentation relative to these loans. We reviewed this information and noted the following problems:

- There were no formal written agreements relative to these loans. For each loan, the Executive Director provided us with a non-letterhead, plain piece of paper with the following written information: date, amount, and one line indicating when the loan was to be repaid and the interest rate to be charged.

- Riverside had no agency policy that allowed for state funds to be used in this manner.

- There was no documentation indicating that Riverside's board was aware of and had approved the use of agency funds for these purposes.

- Riverside's Executive Director did not reimburse Riverside for the entire amount of interest specified in these loan agreements. Specifically, the loan agreements specified that the Executive Director would pay back the principal plus interest at a rate of 6% per year on the outstanding balances. Consequently, when the Executive Director repaid these loans he also owed $2,325 in interest, as indicated in the table below:

Date of Loan/ Interest Paid	Loan amount	Interest Rate	Date of Repayment	Amount of Loan Still Outstanding	Period Outstanding	Interest Due (Interest Paid)
9/10/03	$40,000	6%	4/5/04	$0	6.84 months	$1,368
			4/5/04			(250)
11/9/03	$25,000	6%	4/5/04 and 4/27/04	$0	5 months	625
1/2/04	$38,805	6%	3/31/04	$0	3 months	582
Total Interest Due						$2,325

Riverside's Executive Director stated that these loans were appropriate and should not be viewed as questionable, since he had repaid the initial loan amounts.

b. Questionable and Unnecessary Loans Totaling $190,000 Made by a Lending Institution and by Riverside's Executive Director to Riverside, Resulting in $3,085 in Unnecessary Interest Expenses

The 808 CMR 1.05, promulgated by OSD, identifies the following as nonreimbursable costs under state contracts:

> *(1) Unreasonable Costs. Any costs not determined to be Reimbursable Operating Costs as defined in 808 CMR 1.02 or any amount paid for goods or services which is greater than either the market price or the amount paid by comparable Departments or other governmental units within or outside of the Commonwealth.*

During our audit, we noted that during fiscal years 2002 and 2003, Riverside secured three loans made from either a lending institution or its Executive Director. According to Riverside's records, these loans, which totaled $190,000, were as follows:

Fiscal Year	Date of Loan	Originator of Loan	Loan Amount	Amount Paid Back	Interest Paid	Date Paid Back	Reason for Loan
2002	7/1/01	Fleet Bank	$100,000	$50,000	$2,990	10/10/01	Cash Flow
2002				50,000	0	11/9/01	
2002	9/14/01	Exec. Director	40,000 (but only $37,352 confirmed)	No documentation available	0	Unknown	Cash Flow
2003	10/15/02	Fleet Bank	50,000	50,000	95	11/4/02	Cash Flow
Totals Confirmed			$187,352	$150,000	$3,085		
Total Unconfirmed			$190,000	$190,000			

During our audit we requested from Riverside officials all the information relative to these loans. Based on our review of this documentation, we noted the following problems:

- Riverside could not provide us with an executed loan agreement during fiscal year 2002 or a record of loan repayments. Regarding this matter, on April 28, 2004 Riverside officials provided us with a memorandum that stated, in part;

> *Loan by….[Executive Director] of $40,000 on 9/14/01 was for cash flow purposes. NEHS [Riverside] was unable to access credit line at that time from bank. Documentation for Loan submitted to OSA was a cancelled personal check from …[Executive Director] in the amount of $37,351.58. A discrepancy of -$2,648.42. Unable to locate the remainder of documentation.*

- The only supporting documentation concerning the $150,000 Fleet Bank loans to Riverside and corresponding principal and interest payments was a faxed copy dated April 21, 2004 of Fleet's "Loan Balance History," which was prepared April 16, 2004.

In addition, we believe it was unnecessary for Riverside to borrow these funds, since it had sufficient cash during these two fiscal years to provide profit-sharing distributions and bonuses to its staff that far exceeded (by over $248,000) the amounts Riverside claimed that it had to borrow to meet its cash flow needs, as indicated in the following table below. Consequently, the $3,085 in interest costs that Riverside paid on these loans represent unreasonable costs that should not have been paid by the Commonwealth.

Fiscal Year	Amount Borrowed	Profit Sharing Funding	Bonuses Paid	Excess of Optional Payouts over Borrowed Funds
2002	$140,000	$157,910	$110,060	$127,970
2003	50,000	111,678	58,838	120,516
Total	$190,000	$269,588	$168,898	$248,486

The Executive Director indicated that these loans were for cash flow purposes. He further stated that he was unaware of the need for more board oversight, that additional record keeping was necessary, and that such interest payments would be viewed by the state as nonreimbursable.

Recommendation

Riverside's Executive Director should reimburse the remainder of the interest owed on his loans ($2,325) to Riverside. Also, if Riverside wants to provide loans to members of its staff, including its Executive Director, it should establish formal written policies and procedures approved by its Board of Directors relative to this matter. If Riverside's board approves such policies and procedures, Riverside should maintain adequate records to support such transactions and properly record them in their accounts and financial statements. However, Riverside should ensure that no state funds are used for this purpose. Regarding the borrowing of funds, Riverside should implement sound cash management practices so that it does not borrow funds to fund discretionary expenses such as bonuses.

Finally, OSD, in conjunction with DSS and other oversight agencies, as necessary, should conduct a more comprehensive review of Riverside's loan activities during the period prior to that covered by our audit, as well as of the discrepancy between the $40,000 loan Riverside's Executive Director claimed to have given Riverside versus what was repaid. Based on this

review, OSD and DSS should take whatever measures they deem necessary to resolve this matter.

Auditee's Response

In response to this audit result, a law firm representing Riverside stated, in part:

> *As an initial matter, it is very important to note that none of these funds were charged to state contracts, and all loans were repaid to Riverside. Once again, it is not uncommon or improper for a company to borrow while funding employee plans. If the cyclical nature of cash flow can be smoothed out by short-term borrowing, it is much less disruptive to employee morale to do so than to cut short or delay an anticipated contribution to a pension plan.*
>
> *Nonetheless, Riverside will bring these matters before its Board of Directors for review and approval.*

- Regarding the non-letterhead/non-dated "documentation" of the loans, Riverside indicated, ***"That is sufficient for contract purposes."***

- Regarding interest due, Riverside indicated, ***"This is consistent with the Executive Director's loans to Riverside, for which he charged Riverside no interest. Nonetheless, the Executive Director will offer to make full interest payments to Riverside, less a commensurate interest rate in his loans to the facility."***

- Regarding the $2,648.42 discrepancy indicated in the report, Riverside stated ***"The Executive Director believes that the remaining $2,648.42 may have been his personal payroll check that he endorsed and deposited with the personal check, for a total of $40,000."***

In its response, Riverside also indicated that it would reimburse the remainder of the interest owed on the Executive Director's loans and they would establish formal written policies and procedures approved by its Board of Directors for loans to staff members.

Auditor's Reply

Contrary to what Riverside's asserts in its response, the interest expenses on the loans in question were charged to the state. Specifically, the agency's General Ledgers show these expenses for each fiscal year as an Interest Expense. Also, in the UFRs that Riverside filed with OSD during these fiscal years, these interest expenses were allocated to Riverside's state contracts. In addition, all the loans made to the agency's Executive Director were charged to the agency's operating account, which consists primarily of state funds.

While we acknowledge that in some circumstances firms may need to borrow money to fund pension plans, this is not a good business practice and, in the case of Riverside, is unnecessary. During this period of time, the agency paid out approximately $168,000 in staff bonuses, which are clearly discretionary. If the agency had forgone these bonuses it would have eliminated the need to borrow much of the $190,000. In our opinion, it was not a prudent business action to borrow funds while simultaneously distributing discretionary bonuses.

In its response, Riverside contends that the contract for the loans provided to the agency's Executive Director on non-letterhead paper was sufficient for contracting purposes. However, this document was clearly not sufficient for the purposes of documenting the nature and reasonableness of the expense or properly safeguarding the agency's and the Commonwealth's assets. Specifically,

- Riverside had no agency policy that allowed for state funds to be used in this manner. The state funds provided to Riverside was intended to be used for program-related expenses, not for personal loans made to the agency's Executive Director. Therefore, any funds used for these purposes would be unallowable in accordance with state regulations.

- There was no documentation indicating that Riverside's board was aware of and had approved the use of agency funds for these purposes. Since Riverside's Executive Director and his wife had the ability to complete entire agency transactions from the point of authorization to the reconciliation of bank statements, it was essential that the agency's board be appraised of and approve of any non-program-related use of funds to protect these funds from abuse and misuse.

Consequently, we again recommend that Riverside fully implement our recommendations.

11. INADEQUATE CONTROLS OVER $118,681 IN CONSULTANT SERVICES

Contrary to state and federal regulations, during calendar years 2001 through 2003, Riverside paid 10 consultants a total of $118,681 but did not issue them an Internal Revenue Service (IRS) Form 1099. In addition, we found that Riverside did not exercise sound contract administration practices relative to these consultant services. For example, for nine of the 10 consultants, there was no documentation that indicated that Riverside utilized a competitive procurement process when procuring these consultant services, and Riverside did not enter into a formal written contract with these consultants. Finally, we found one instance in which Riverside paid one individual as both a consultant and an employee. According to this consultant, he was hired by Riverside as a contractor to do landscaping and maintenance work, but Riverside's Executive

Director, who was his friend, agreed to place him on Riverside's payroll as an employee, so that when his contract was over he could get laid off and collect unemployment benefits. The specific problems we identified during our review in this area are discussed below:

a. Failure to Issue IRS Form 1099 to Consultants

Code of Federal Regulations (CFR), Title 26, Chapter 1, Section 6041, "Return of information as to payments of $600 or more," states, in part:

> *(i) Payments required to be reported. Except as otherwise provided in Secs. 1.6041-3 and 1.6041-4, every person engaged in a trade or business shall make an information return for each calendar year with respect to payments it makes during the calendar year in the course of its trade or business to another person of fixed or determinable income described in paragraph (a)(1)(i) (A) or (B) of this section. For purposes of the regulations under this section, the person described in this paragraph (a)(1)(i) is a payor.*
>
> *(A) Salaries, wages, commissions, fees, and other forms of compensation for services rendered aggregating $600 or more....*

Additionally, the Massachusetts Department of Revenue has similar requirements governing the reporting of compensation to individuals and identifies the following as being income that must reported by individuals:

> *All compensation to an employee for services performed. Payments subject to Massachusetts withholding include wages, salaries, tips, commissions, bonuses, fees or any other item of value paid to an individual for services performed as an employee.*

During our audit period, Riverside paid 10 consultants $118,681 but, contrary to IRS regulations, failed to issue IRS Form 1099s to these individuals, as detailed in the following table:

Paid Riverside Consultants
Not Issued Form 1099
Calendar Years 2001 through 2003

Type of Service	Number of Individuals	2001	2002	2003	Total
Consultants	4	$4,505	$60,355	$11,298	$76,158
Subcontractors	1	0	12,440	4,086	16,526
Maintenance/ Repairman	3	0	2,760	5,770	8,530
Compensation to Two Board Members	2	0	1,207	16,260	17,467

Total	10	$4,505	$76,762	$37,414	$118,681

The Internal Revenue Service Code specifies that taxpayers must file income information Form 1099s for each person to whom they have paid at least $600 in a year. Not filing such forms is a violation of federal law, and penalties could be assessed against Riverside.

b. Inadequate Contract Administration Activities

The state's Executive Office for Administration and Finance, the Office of the State Comptroller, and OSD have jointly promulgated the "Commonwealth Terms and Conditions for Human and Social Services" (General Contract Conditions), with which all contracted human-services providers, such as Riverside, must comply. Regarding the procurement of goods, services, and subcontracts, the General Contract Conditions state, in part:

> *The provider shall establish and maintain written procedures for the procurement of goods, services (including personal services) and subcontracts.*

Furthermore, according to federal guidelines, agencies that receive federal funds, as Riverside does, must use a competitive-bidding process when procuring goods and services. Specifically, Office of Management and Budget (OMB) Circular A-110, Appendix A, Subpart B, Section 43, states, in part:

> *All procurement transactions shall be conducted in a manner to provide, to the maximum extent practical, open and free competition....*

Additionally, Section 39(b), Attachment B, of OMB Circular A-122, "Cost Principles for Non-Profit Organizations," with which Riverside must comply, states, in part:

> *In determining the allowability of costs in a particular case, no single factor or any special combination of factors is necessarily determinative. However, the following factors are relevant:*
>
> - *The nature and scope of the service rendered in relation to the service required.*
> - *The necessity of contracting for the service, considering the organization's capability in the particular area....*
> - *Whether the service can be performed more economically by direct employment rather than contracting.*
> - *The qualifications of the individual or concern rendering the service and the customary fees charged....*

- *Adequacy of the contractual agreement for the service (e.g., description of the service, estimate of time required, rate of compensation, and termination provisions)….*

Based on our review of the documentation Riverside was maintaining relative to these 10 consultants, we noted the following problems:

1. For nine of the 10 individuals, Riverside did not maintain various required consultant documentation, including the following:

   - Formal contracts specifying the rate of compensation, scope of services, contract length, etc.
   - Evidence of a competitive-bidding process to procure the services
   - Evidence that the services paid for were actually provided
   - Credentials (e.g., resumes, certifications, evidence of qualifications)
   - Documentation that the services procured were actually needed

2. The majority of the consultant invoices we reviewed were inadequate because they did not specify a rate of compensation, dates on which the services being billed were provided, and a description of the services provided.

b. Questionable Employment Status of One Consultant

During fiscal years 2003 and 2004, Riverside paid one individual as both a consultant and as an employee. We interviewed this individual, who stated that he did have a service contract with Riverside, and provided us with a copy of it. The contract he provided us, which was dated March 15, 2003, listed various landscaping and maintenance/repair work to be performed at Riverside. The contract specified that the amount to be paid to the subcontractor "will not exceed $45,000" and would be paid between April and December of 2003.

Although Riverside did have a contract with this subcontractor, it did not maintain any other documentation relating to this individual. Also, during our interview with this subcontractor, he stated that he asked Riverside's Executive Director, with whom he had been a friend for some time, to pay him both as a contractor and as an employee. The subcontractor stated that this would allow him to make quarterly payments to the IRS and to qualify him for unemployment, which he would collect in the winter due to the seasonal nature of his landscaping and contracting company. He indicated that when he was added to Riverside's

payroll, he was listed as a "maintenance person"; however, he did not report to the head of maintenance, but rather reported directly to the Executive Director.

The subcontractor further explained that when he was paid as an employee, he was not paid by the hour, but rather by the completion of certain jobs. The table below details the quarterly dates and amounts of payroll checks Riverside paid this individual, as well as the dates and amounts of checks paid to him as a contractor:

Analysis of Contractor Payments

Fiscal Year 2003 through March 31, 2004

Payments as an Employee		Payments as a Contractor	
Quarter End Date	Amount	Date	Amount
12/30/02	$10,500	3/23/02	$3,000
3/31/03	0	4/11/02	3,090
6/30/03	32,500	4/18/02	6,350
9/30/03	10,000	1/29/03	379
12/30/03	5,000	4/24/03	2,502
-	-	4/30/03	175
-	-	8/10/03	1,030
Total	$58,000	Total	$16,526

As can be seen from the table above, this individual had a contract with Riverside indicating that he would be paid up to a maximum of $45,000. However, during the period of his contract, he was paid $58,000 as an employee and simultaneously paid $16,526 as a contractor for his services.

The Executive Director explained that Riverside's failure to issue a Form 1099 to the consultants in question was an oversight, and that Riverside does not have a system in place to identify which individuals should receive them. However, the Executive Director did not comment on the problems we found with Riverside's contract administrative activities or why he paid one consultant as both an employee and a consultant.

Recommendation

Riverside should immediately establish procedures to identify consultants who receive more than $600 per calendar year and who should receive IRS Form 1099. In addition, Riverside should issue a Form 1099 for calendar years 2001 through 2003 to those individuals identified by our audit. Regarding the subcontractor who was paid as both an employee and a consultant, we will be referring this matter to the appropriate oversight agencies for their review and resolution.

Auditee's Response

In response to this audit result, a law firm representing Riverside stated, in part:

Riverside will implement policies, procedures and controls to provide for closer contract administration, and will take reasonable steps to ensure that it issues IRS Form 1099's for each independent contractor. Riverside will also have all its contractor arrangements reviewed by its Board of Directors.

Regarding the individual who performed services as an employee and as an independent contractor, it is not improper, per se, to offer an independent contractor employment, or to contract with an employee to provide independent contractor services that are outside his or her employment function. This person performed distinct services as an employee and as an independent contractor.

- *The services were performed, they were related to the program, and the charges for the services were not excessive. In addition, it should be noted that at least $40,000 of the $60,355 in consultant services in 2002 was paid to a consultant whom OCCS required Riverside to retain to review Riverside's behavior management plan. This individual had to be approved by OCCS. Consequently, there would have been no "insider" reason for not issuing a Form 1099. It is further evidence that these omissions were merely oversights.*

- *That the services were performed should be self-evident. The services included preparing the UFR and other OSD requirements, bookkeeping review, billing, behavior management plan review and redesign (required by OCCS), development of an emergency evacuation plan (required by DOR).*

- *Riverside is preparing a review of all services for presentation to and, if appropriate, ratification by, its Board of Directors.*

- *Riverside objects to the use of the term "competitive-bidding process" as a standard. Neither the Federal nor State regulations cited by the auditors utilize that term. In fact, "bidding" is not referred to as a requirement at all. The General Contract Conditions only require the provider to "establish and maintain written procedures for the procurement of goods, services (including personal services) and subcontracts." As noted, previously, Riverside is in the process of reviewing, revising and adopting its practices and procedures in all aspects of its operation, including procurement of goods and services. In addition, as cited by the auditors, OMB Circular A-110, Appendix A, Subpart B, Section 43, states, in part, that "[a]ll procurement transactions shall be conducted in a manner to provide, to the maximum extent practical, open and free competition . . . ." This is not the same as engaging in a "bidding" process. Finally, as cited in the report, Section 39(b), Attachment B, of OMB Circular A-122 provides that in determining the allowability of costs certain*

factors are relevant, but not necessarily determinative (scope of service, necessity of contracting, qualifications of contractors, and adequacy of the contractual agreement). Significantly, "bidding" is not among the factors.

Concerning the contractor, Riverside provided the following comments:

- *The Executive Director is not a personal friend of this contractor. The contractor met the Executive Director through the contractor's sister, who was a long-time employee of Riverside. The contractor does not have a social or personal relationship with the Executive Director.*

- *The Executive Director never suggested to this person that if he became an employee of Riverside the Executive Director would lay him off so he could collect unemployment benefits, and if this was the person's intent, the Executive Director was not aware of it. The Executive Director only knew that this person had given him a bid for the work as a contractor, but said that he could perform the work cheaper as an employee. As this was a cost savings to Riverside, the Executive Director agreed to employ the person.*

- *Riverside did not have a "head of maintenance." There was just one maintenance person, and he held the title of "maintenance supervisor." Once again, the Executive Director had this person report directly to him to keep administrative costs down.*

- *This employee was paid for piece work.*

- *If the "period of his contract" is defined as beginning on 3/15/03 (the date of the contract), then this person only received $47,500 as an employee for the period. Also, it is important to note that this person rendered distinctly difference services to Riverside in his roles as employee and independent contractor. As an employee, his duties were to oversee the maintenance and expansion of the facility's parking lot. This included cutting down trees, clearing land, and paving to and in the street. As an independent contractor, he provided building services, such as partitioning rooms, putting up sheetrock, etc. Finally, this person did not render services "simultaneously" as an employee and as a contractor. The only "overlap" on the above chart is a payment on 8/10/03 for $1,030.00 in the "contractor services" column. Upon information and belief, however, this did not represent payment for services rendered by this person, but payment for supplies delivered (i.e., loam, bark mulch, or other landscaping supplies). Consequently, the payment is in the nature of an expense paid to a vendor.*

Auditor's Reply

In its response, Riverside states that it is going to take measures to address our concerns in this area. We believe such measures are necessary and appropriate.

The agency also contends that it is not improper for a company like Riverside to have an employee also provide work as an independent contractor if it is outside of the scope of work he is performing as an employee. However, despite the assertions made by Riverside in its response, although Riverside did have a contract with this subcontractor, it did not maintain any

other documentation relating to this individual that indicated the services he was going to perform as an employee opposed to those he was going to perform as a contractor. Also, during our interview with this subcontractor, he did in fact state that he asked Riverside's Executive Director, with whom he had been a friend for some time, to pay him both as a contractor and as an employee. The subcontractor stated that this would allow him to make quarterly payments to the IRS and to qualify him for unemployment, which he would collect in the winter due to the seasonal nature of his landscaping and contracting company. He indicated that when he was added to Riverside's payroll, he was listed as a "maintenance person"; however, he did not report to the Maintenance Supervisor, but rather he reported directly to the Executive Director. The subcontractor further explained that when he was paid as an employee, he was not paid by the hour, but rather by the completion of certain jobs. Given the comments made by this individual to us during our audit and the fact that the agency did not have any other documentation relative to the services performed by this individual, we believe that it was necessary and proper for us to question the compensation provided to him during the period of our review. We cannot comment on Riverside's representations as to the services provided by this contractor because, as previously mentioned, the agency did not have any records to document what services this individual provided.

In its response, Riverside contends that neither state nor federal regulations require "bidding" for goods and services. However as noted in our report, regarding the procurement of goods, services, and subcontracts, the General Contract Conditions state, in part:

> *The provider shall establish and maintain written procedures for the procurement of goods, services (including personal services) and subcontracts.*

Furthermore, according to federal guidelines, agencies that receive federal funds, as Riverside does, must use a competitive-bidding process when procuring goods and services. Specifically, Office of Management and Budget (OMB) Circular A-110, Appendix A, Subpart B, Section 43, states, in part:

> *All procurement transactions shall be conducted in a manner to provide, to the maximum extent practical, open and free competition....*

Further 808 CMR 1.05(8) promulgated by OSD states:

> *Procurement of Contractor Furnishings, Equipment and Other Goods and Services. All procurements of furnishings, equipment and other goods and services by or on behalf of*

> *a Contractor shall be conducted in a manner to provide, to the maximum extent practical, open and free competition. Capital Items, as defined in 808 CMR 1.02, shall be acquired through solicitation of bids and proposals consistent with generally accepted accounting principles.*

Riverside was clearly not in compliance with the requirements of the terms and conditions of its state contracts that require it to have written policies and procedures for the competitive procurement of goods and services. While some of the criteria cited in our report may not contain the specific term "bidding," it is clear that one cannot conduct a fair and open competitive procurement process without soliciting price competition. Whether you call this process the solicitation of quotes instead of bids is simply a matter of semantics. The key is to have a process that employs open competition, which Riverside could not demonstrate that it utilized for the contracts in question.

In its response, Riverside claims that the services provided should be "self evident." However clearly, even if the type of service provided in some instances may be evident, this does not mitigate Riverside's responsibility to properly administer its contracts.

Also, the majority of the consultant invoices we reviewed were inadequate because they did not specify a rate of compensation, dates on which the services being billed were provided, and a description of the services provided. As such, it was clearly necessary and proper for us to question the reasonableness of the state funds that were used by Riverside to pay for these services.

12. RIVERSIDE EXPENSED CAPITAL ITEMS TOTALING $73,936 RATHER THAN DEPRECIATING THESE COSTS AS REQUIRED BY STATE REGULATIONS

We found that during our audit period, Riverside expensed $73,936 in capital assets against is state contracts rather than depreciating the cost of these assets over their useful lives as required by state regulations. Consequently, the $73,936 in expenses represent nonreimbursable costs under Riverside's state contracts.

OSD has promulgated 808 CMR 1.05, which applies to all contracted human services providers such as Riverside, and identifies the following costs as nonreimbursable under state contracts:

> *(4) Current Expensing of Capital Items. All costs attributable to the current expensing of a Capital Item.*

(26) Undocumented Expenses. Costs which are not adequately documented in the light of the American Institute of Certified Public Accountants statements on auditing standards for evidential matters.

OSD also provides the following guidance in its UFR Audit and Preparation Manual:

Generally accepted accounting principles require that purchases having a future economic benefit and life beyond one year be capitalized and depreciated over a certain time period. In addition, the provisions of FASB No. 116 indicate that the revenue should not be recorded in a temporary or permanently restricted class as these classifications are restricted for donations. Depreciation of an asset furnished under a Commonwealth Capital Budget is considered non-reimbursable and should be reported on Supplemental Schedules A and B. The obligation to report funds not derived for Commonwealth revenue to offset the non-reimbursable cost of depreciation from the asset furnished by the Capital Budget Contract is met by indicating on Schedule A and B that the depreciation is offset by revenue derived from the Capital Budget Contract (in essence, no offsetting revenue is necessary). Contractors with programs that are supported by funding from the Commonwealth must record depreciation for those programs in accordance with the Massachusetts Code of Regulation 808 CMR 1.00 and Federal Single Audit requirements of OMB Circular A-l22 and/or A-21. Programs which are not supported by funding from the Commonwealth or Federal Assistance must record depreciation in accordance with ANPO recommendations, but may utilize reasonable service lives that may differ from the 808 CMR 1.00 and OMB Circular A-122 lives. The Massachusetts Code of Regulation 808 CMR 1.00 subscribes to the above but requires that depreciation be reported on the supplemental schedules on a straight-line basis over a service life not less than the periods given as follows:

Schedule of Service Lives of Assets

ASSET CATEGORY	YEARS OF LIFE	YEARLY RATE
Buildings:		
Type 1 - Fireproof Construction and Type 2 - Non-Combustible Construction (as classified by the State Board of Building Regulations and Standards in accordance with 780 CMR 400.00)	40	2.5%
Type 3 - External Masonry Wall Construction and Type 4 - Frame Construction (as classified by the State Board of Building Regulations and Standards in accordance with 780 CMR 400.00)	27.5	3.6%
Building/Improvements	20	5.0%
Leasehold Improvements	5 (or term of lease, whichever is greater)	20.0%
Equipment	10	10.0%
* Computer Equipment	3	33.33%
** Other Office and Other Program Equipment: Includes items such as copiers, ovens, washers, dryers, office files and capitalized office and program supplies.	5	20.0%
Life Safety Improvements: Building or leasehold improvements or equipment acquisitions made solely to satisfy the requirements of any Department regarding life safety or physical environment. Purpose must be documented.	5	20.0%
Motor Vehicles	5	20.0%
Used Motor Vehicles	3	33.33%
Residential Furnishings	3	33.33%
Office Furnishings	7	14.2%

* Denotes decreased years of life, effective January 1, 1997.

** Denotes additional category, effective January 1, 1997.

During our audit, we found that Riverside had no formal written policies and procedures in place relative to the capitalization, depreciation, and disposal of its capital assets. Consequently, we identified all furniture, repair, and equipment expenditures made by Riverside during our audit period, and selected a judgmental sample of 81 transactions totaling $185,186, which represented 42% of the dollar value of all purchases of capital items made through Riverside during this period. We then reviewed all of the records Riverside was maintaining relative to these capital items, and identified assets totaling $131,648 that were expensed by Riverside during this year of acquisition that instead should have been capitalized by Riverside as required by OSD regulations. The nonreimbursable portion of the $131,648 in capital assets that Riverside charged against its state contracts totaled $73,936, as indicated in the table below:

Fiscal Year	Total	State of MA	Cities/Towns	State of NH	Other
2002	$72,603	$43,562	$22,507	$7,260	($726)
2003	42,010	21,005	15,124	5,881	0
2004	17,035	9,369	3,918	3,748	0
Totals	$131,648	$73,936	$41,549	$16,889	($726)

Regarding this matter, Riverside's Executive Director indicated that carpets, furniture, and other such assets are expensed because they do not last more than one year and that he had been instructed to handle these expenses in this manner by his accountants.

Recommendation

DSS should recover from Riverside the $73,936 in unallowable capital asset expenses it charged against its state contracts during our audit period. In the future, Riverside should establish a formal policy with written procedures and internal controls for the purchasing of fixed assets and have it approved by its Board of Directors. Moreover, Riverside should maintain adequate records to support such transactions, including bidding documentation, purchase orders, and inventory tags, and properly record them in its General Ledger and financial statements to the state.

Auditee's Response

In response to this audit result, a law firm representing Riverside stated, in part:

> *Riverside believes these items were legitimately classified as expenses, not capital improvements. Riverside respectfully disagrees with the auditors' reading and*

interpretation of the UFR Audit and Preparation Manual cited by the auditors. According to the UFR Manual, "[g]enerally accepted accounting principles require that purchases having a future economic benefit and life beyond one year be capitalized and depreciated over a certain time period," such time period being established by the "Schedule of Services Lives of Assets." The auditors interpret this to mean that all purchases having a useful life of more than one year according to the "Schedule of Services Lives of Assets" must be capitalized and depreciated according to the "Schedule of Services Lives of Assets." This reasoning is circular, however. Instead, the UFR Manual requires one to first determine whether the purchase has a "future economic benefit and life beyond one year." If not, it may be expensed. The "Schedule of Services Lives of Assets" is not a set of criteria for determining whether a purchase is a capital item; the Schedule is a formula for determining how long the depreciation period is once the item has been determined to be a capital expense. As the auditors noted, many of the items were expensed because they do not last more than one year due to extremely hard use by the students. Accordingly, it is reasonable and appropriate to treat such items as expenses because they do not meet the UFR Manual's definition of a capital improvement.

In addition, the report does not indicate a computation for depreciation that the auditors believe should have been charged annually for the items in question. Certainly, if the auditors believe that an item may not be expensed and must instead be capitalized, the recommendation by the auditors should be set-off against the amount of depreciation…

Auditor's Reply

Contrary to what Riverside asserts in its response, our report does not present an interpretation of OSD's UFR Audit and Preparation Manual. Rather, our report clearly states that OSD has established regulations and guidelines as to how contracted human service providers such as Riverside should depreciate their capital assets. We agree with Riverside's comments that the UFR Manual requires one to first determine whether the purchased item has a future economic benefit and life beyond one year and that the Schedule of Services Lives of Assets is a formula for determining how long the depreciation period is once the item has been determined to be a capital expense. However, as stated in our report, during our audit, we found that Riverside had no formal written policies and procedures in place relative to the capitalization, depreciation, and disposal of its capital assets. We therefore reviewed each furniture and equipment purchase made by the agency during fiscal years 2001 and 2003 and determined that, contrary to Riverside's contention, the assets in question did in fact have a future economic life greater than one year and therefore should have been capitalized as required by OSD regulations.

Regarding Riverside's comment that we should have calculated an amount of depreciation expense that should be allowable, as stated in our report, OSD regulations identify the following as being non-reimbursable costs under state contracts

> *(4) Current Expensing of Capital Items. All costs attributable to the current expensing of a Capital Item.*

This regulation clearly states that all costs associated with the current expensing of capital items are non-reimbursable expenses under state contracts. The regulation does not provide for any omission of expenses (e.g., the amount that should have been depreciated) once this regulation has been violated. Since Riverside expensed the entire purchase price of the items in question, the regulations require that we identify the entire amount as being non-reimbursable and recommend the recoupment of the state funds that were associated with these transactions.

13. INADEQUATE OVERSIGHT BY RIVERSIDE'S BOARD OF DIRECTORS

The Board of Directors of a human service provider agency is the primary organizational body that ensures that an 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. However, we found several deficiencies relative to the activities of Riverside's Board of Directors. Specifically, there was no documentation to substantiate that it complied with all of the conditions of its state contracts relative to the approval of compensation for Riverside's Executive Director or the selection of Riverside's audit firm, and inadequate documentation to substantiate that the board complied with Riverside's corporate bylaws relative to the review and approval of agency expenses.

Section 6A of Chapter 180 of the Massachusetts General Laws, commonly referred to as the Public Charities Law, empowers not-for-profit organization such as Riverside to make, amend, and repeal bylaws that prescribe the number, term, powers, and responsibilities of its Board of Directors, officers, and Executive Director. In addition, the state's Executive Office for Administration and Finance and the Operational Services Division/Division of Purchased Services has promulgated terms and conditions for Human and Social Service Contracts (Contract Conditions). Regarding an agency's Board of Directors, Condition 11 of the Contract Conditions states:

> *If a non-profit organization, the Provider will comply with the principles contained in the Massachusetts Attorney General's "Guide for Board Members of Charitable Organizations" and with the standards for boards contained in the AICPA's statements on auditing standards, as may be amended from time to time. Further, the Provider specifically agrees to the following:*

- *the Provider's board of directors will approve the selection of the Provider's audit firm;*

- *the Provider's board of directors will, on an annual basis, review its Executive Director's or other most senior manager's performance and set the person's compensation by a formal vote;*

- *by July 1, 1996, members of the Provider's management and immediate family members of Provider management will not comprise more than 30 percent of the voting members of the Provider's board or of any of the board's committees or subcommittees. For the purpose of this paragraph, "immediate family member" shall have the meaning ascribed to it in the AICPA's Financial Accounting Standards Board Statement Number 57; and,*

- *the Provider's board of directors will meet as frequently as necessary to fulfill the Provider's obligations under this section. Where the board meets less than two times during its fiscal year, the Provider shall submit a description of its board structure and the dates of each board and subcommittee meeting with its UFR. In addition, condition seven of the terms and conditions requires contractors to maintain conflict of interest and nepotism policies.*

Despite these specific requirements, during our audit, we found a number of problems relative to the Board of Directors' oversight of Riverside, as follows:

- As previously noted, the state's Contract Conditions require an agency's Board of Directors to annually review its Executive Director's performance and set that person's compensation by formal vote. Additionally, the state's Office of the Attorney General has published guidelines on the duties and responsibilities of members of the Board of Directors of nonprofit organizations. According to these guidelines, "Even if a compensation committee is used it should not make the final decision." These guidelines further state that the "process for setting CEO compensation, the amount of such compensation, and the terms of such compensation shall be approved by the full board and be sensitive to public concerns." During the period of our audit, Riverside's Executive Director received salary and fringe benefits totaling $302,051 as well as $88,195 in profit sharing compensation and $27,170 in bonus payments, of which $165,003, $47,772, and $27,170, respectively, was charged to state programs. During our audit, we noted that the personnel file of Riverside's Executive Director contained no evidence of an annual performance evaluation conducted by Riverside's board, contrary to this statute. Also, our review of the minutes of the meetings of Riverside's Board of Directors did not indicate that the board was aware of or had approved of any of the bonuses or profit sharing compensation Riverside's Executive Director received or whether the Executive Director's performance was assessed in making the salary and bonus determinations as required by the Contract Conditions.

- There was no evidence in the board minutes that Riverside's board approved the selection of Riverside's audit firm, contrary to the Contract Conditions.

- Riverside's corporate bylaws require that the Treasurer of its board "have general charge of the financial affairs of the Corporation and shall keep full and accurate books of

account. The Treasurer shall maintain custody of all funds, securities and valuable documents of the Corporation…." However, as noted throughout this report, Riverside's Treasurer was not performing any of these activities.

- There is no documentation to substantiate that Riverside's board approved or reviewed Riverside's disbursements on a routine basis. In fact, there was no indication that the board approved any of the $11,081,121 expended by Riverside during the audit period July 1, 2001 through March 31, 2004.

- According to guidelines published by the Office of the Attorney General, board members should be able to perform their duties and responsibilities in a fair and equitable manner, free from any conflicts. However, Riverside's Executive Director is also President of the corporation, elected by the Board of Directors, and a board member with full voting powers. Given that Riverside's Executive Director is also the President of the corporation, with power to make committee appointments with full voting powers and the ability to delegate authority to himself, his ability to perform these tasks in an independent and equitable manner is questionable.

- Riverside has not established formal conflict-of-interest or nepotism policies for its Board of Directors.

Regarding these matters, the Executive Director stated that he believed Riverside's board was performing adequate oversight of Riverside and its activities.

Recommendation

In order to address our concerns relative to this matter, Riverside should take the measures necessary to ensure that the composition and activities of its Board of Directors complies with the requirements of its corporate bylaws, state regulations, and the guidelines issued by the Office of the Attorney General.

Auditee's Response

In response to this audit result, a law firm representing Riverside stated, in part:

> *Riverside now recognizes that it needs to provide more detailed information to its Board of Directors, and to engage the Board members regularly in its operations. The Board will review its responsibilities under its bylaws, the Attorney General guidelines, and the OSD Contract, and ensure compliance with the same. . . .*
>
> *It is not impermissible for a corporate officer to delegate his or her duties, as long as the officer retains oversight. As mentioned previously, the Executive Director, who is also the Treasurer, maintained complete control over the day-to-day operations of Riverside, including all financial functions. That he did not perform some of the functions himself does not mean that he failed to meet his duties under the bylaws.*

Moreover, this is not an accurate quote regarding the duties of Riverside's Treasurer as set forth in the bylaws. The bylaws state that the Treasurer "shall have the power to manage the financial affairs of the corporation. The Treasurer shall keep the books and records of the financial affairs and make such available to the President and Board of Directors upon request. The Treasurer may make recommendations to the officer and directors in regard to the financial affairs of the corporation.". . .

Riverside's bylaws do not mention an Executive Director at all. . . .This misconstrues what is a fairly common practice in many corporations – both for-profit and non-profit. There is often one person in the role of President and Chief Executive Officer (and the Executive Director is effectively the CEO at Riverside). This person almost always sits on the Board of Directors, ex officio, and may sit either with or without vote. Moreover, the report overlooks the fact that the President has only one seat, and only one vote, on the Board. The other Board members still oversee his actions as both a President and an Executive Director. As the President cannot pass any vote of the Board by himself, there is sufficient oversight built into the bylaws.

Auditor's Reply

In its response, Riverside acknowledges that it needs to provide more detailed information to its Board of Directors and involve them more in agency operations. We agree; however, as stated in our report, Riverside also needs to ensure that its board is meeting all of its oversight responsibilities, including performing annual evaluations of the agency's Executive Director and formally documenting any compensation changes to the Executive Director that were approved by the board; selecting the agency's audit firm; and, where applicable, reviewing and approving significant agency expenses.

Our report clearly delineates that there are more members of Riverside's board than just the agency's Executive Director. In fact, many of the oversight deficiencies we identify in our report deal with the board as a whole, and not just one individual board member. For example, we point out in our report that during our audit, we noted that the personnel file of Riverside's Executive Director contained no evidence of any of the required annual performance evaluations conducted by Riverside's board. Also, our review of the minutes of the meetings of Riverside's Board of Directors did not indicate that the board was aware of or had approved of any of the bonuses or profit-sharing compensation Riverside's Executive Director received, or whether the Executive Director's performance was assessed in making the salary and bonus determinations as required by the Contract Conditions. We also found that there was no evidence in the board minutes that Riverside's board approved the selection of Riverside's audit firm, contrary to the Contract Conditions. Further, we found that there was no documentation to substantiate that Riverside's board approved or reviewed Riverside's disbursements on a routine basis. In fact,

there was no indication that the board approved any of the $11,081,121 expended by Riverside during the audit period July 1, 2001 through March 31, 2004.

We agree that it is not unusual for an organization's Chief Executive to be member of its board. However, in most instances, sufficient controls exist over the activities by board members to prevent the Chief Executive from taking actions that would be in his or her self interest as opposed to the best interest of the organization. However, no such controls exist within Riverside's board. Based on its response, Riverside is going to take measures to address our concerns in this area. We believe such measures are necessary and will serve to better maintain the integrity of the financial and other activities conducted by the agency.

We do not agree with Riverside's assertion that, "As the President cannot pass any vote of the Board by himself, there is sufficient oversight built into the bylaws." Voting rights alone do not constitute sufficient oversight. Oversight includes meeting all of the responsibilities as specified in the agency's corporate bylaws, terms, and conditions of the agency's state contracts and guidelines issued by the Office of the Attorney General. While the board voting process may limit the power of one individual from making unilateral decisions, it does not serve as a supplementary control to the board meeting all of its oversight responsibilities. As noted in our report, based on the information we were provided, Riverside's board was not sufficiently meeting all of its oversight responsibilities during the period covered by our review. In fact, the board has not even established controls such as formal conflict-of-interest or nepotism policies that would serve to ensure that it can meet its oversight responsibilities without conflicts or the appearance of conflicts.

14. INADEQUATE ADMINISTRATIVE AND INTERNAL CONTROLS OVER AGENCY OPERATIONS

We found that Riverside had not developed and implemented an adequate system of internal controls over many aspects of its operations. Specifically, we found that Riverside did not properly document its accounting system; did not adequately segregate the duties of its administrative staff; did not maintain all of its records in accordance with state regulations; failed to establish an effective inventory system for its fixed assets, which as of June 30, 2003 totaled $355,468; and did not maintain its accounting records in accordance with GAAP. As a result, the Commonwealth cannot be assured that public funds were properly safeguarded against

misuse and expended for their intended purposes, or that all of Riverside's transactions were properly authorized, recorded, and reported.

According to GAAP, entities such as Riverside should establish and implement an adequate internal control system within the organization to ensure that goals and objectives are met; resources are used in compliance with laws, regulations, and policies; assets are safeguarded against waste, loss, and misuse; and financial data is maintained, reported, and fairly disclosed in reports. In order to comply with GAAP, Riverside should have a documented comprehensive plan of internal control describing its goals and the means by which these goals and objectives are to be achieved. An effective internal control system would establish clear lines of authorization and approval for its various business functions, such as purchasing, contracting, asset management, travel, payroll, and personnel, and would identify supervisory personnel and their responsibilities. In addition, an entity's internal control system should be backed up with a set of detailed subsidiary policies and procedures that would communicate responsibilities and expectations to subordinate staff throughout the organization. These policies and procedures would provide direction to employees on how to complete the various business functions, such as accounting, billing and receiving, cash receipts, accounts payable, human resources, and payroll.

However, we found that in addition to the other internal control deficiencies discussed in this report, Riverside had not established adequate internal controls over many other aspects of its operations. The following is a summary of the additional internal control deficiencies we identified during our audit.

- Failure to Document Riverside's Accounting System: Sound business practices advocate that entities such as Riverside establish a proper accounting system that is documented in formal policies and procedures and a written accounting manual that describes the accounting system and the policies and procedures utilized in the agency's accounting process. Such a manual not only maintains the integrity of the accounting process and its continuity in case of staff turnover, but also establishes accountability of various operations. However, during our review we noted that Riverside had not established formal written accounting procedures or an accounting manual.

- Failure to Maintain Records in Accordance with State Regulations: According to 808 CMR 1.04 (1) promulgated by OSD, entities such as Riverside are required to maintain all financial records relative to revenue and expenses in accordance with GAAP, as set forth by the American Institute of Certified Public Accountants, for a period of seven years. However, as noted throughout this report, Riverside officials were often unable to

provide us with specific documentation requested during the audit. Additionally, we noted numerous discrepancies in Riverside's financial records. For example, there was no documentation to substantiate all adjusting entries to Riverside's General Ledgers during our audit period, and we noted that a check dated August 2, 2003 was cashed on July 31, 2003, two days before it was issued.

- Lack of Segregation of Duties within Accounting Functions: An effective internal control structure ensures adequate segregation in the duties and responsibilities of individuals involved in the custody of assets, the authorization and recording of transactions, and the reconciliation of records. During our audit, we determined that Riverside lacked this segregation of duties. Specifically, we found that the Executive Director received the invoices, had total authority to decide what to pay, instructed the Bookkeeper (his wife) to issue the checks, and authorized the check. In addition, when goods and services were received, the Executive Director failed to have another agency official sign that these goods and services were actually received and indicate the specific program purposes. Further, the Executive Director was also responsible for making deposits and supervising the consultant he hired to record these transactions. In fact, all accounting consultants, who were hired to supplement the Bookkeeper in maintaining Riverside's records, were directly supervised solely by the Executive Director. As a result of this lack of segregation of duties, numerous questionable transactions occurred, as noted throughout our audit report.

- Failure to Maintain an Accurate Inventory System: The 808 CMR 1.04, promulgated by OSD, states the following with regard to inventory of equipment and furnishings and other goods: "Any Contractor in possession of Capital Items . . . shall maintain and keep on file a written inventory of the property in accordance with generally accepted accounting principles." However, during our audit we found that Riverside did not have a listing of its fixed assets (nonexpendable items with a useful life of more than one year) in accordance with state regulations, which according to its fiscal year 2003 financial statements had a value of $355,468.

In addition, we noted the following questionable costs relative to furnishing and equipment items:

- An invoice for $13,000 for furniture that did not include any purchase order or shipping detail.

- The purchase of computer systems, as detailed in the table below, with no documentation as to who received them or where they were located.

Company	Date	Amount	Description
URS Info System	11/9/2001	$1,182	Computer system for Riverside's Executive Director

URS Info System	12/11/2002	$2,022	Two computer systems
URS Info System	12/31/2002	$1,408	Computer system for Riverside's Executive Director
URS Info System	3/8/03	$1,989	Two computer systems

- The following purchases of carpeting for which no bids were received and no purchase orders on file at Riverside. Also, there were no signatures by resident directors or managers on receiving reports indicating where this carpeting was installed.

Company	Date	Amount	Description
Lechmere Rug	10/24/01	$16,717	Sold to Institute for Living for 258 and 475 Varnum Avenue; no other details provided.
Lechmere Rug	12/21/01	$ 1,921	Furnish and install carpet; no other details provided.
Lechmere Rug	11/30/02	$11,500	For 666 sq. ft. of "antique moss" at $16.95/ sq.ft. plus installation; no other details provided.
Lechmere Rug	8/25/03	$ 9,888	Invoice only for $7,888. Riverside overpaid this vendor by $2,000. According to Riverside officials, it was for carpeting nine rooms and hallways at 34 Berry Road.

Regarding these matters, Riverside's Executive Director stated that because his organization was a small agency, his main focus has been on operations and keeping the accounting costs low by keeping the accounting department small. Consequently, some of the controls that we deemed necessary have not been implemented.

Recommendation

Riverside should immediately develop and implement a written system of internal controls over all aspects of its operations in order to ensure that its financial records are properly maintained and that its financial activities are properly authorized, recorded, and reported.

Auditee's Response

In response to this audit result, a law firm representing Riverside stated, in part:

> *Riverside is aware that it needs to develop policies and procedures regarding its accounting functions, and is working to do so. Riverside's main focus, however, has been to provide quality education services to special needs students at a reasonable rate. In its zeal to keep expenses low, Riverside maintained many of its accounting practices that worked well when Riverside was smaller, but which had failed to grow with its operation. Riverside is working on remedying that aspect of its business….*
>
> *There were not enough administrative employees to segregate the functions. It would have required Riverside to hire additional non-student staff, which would have unnecessarily increased the cost to the state. Once again, Riverside was just trying to be efficient."*

Auditor's Reply

As noted in our report, we found that Riverside had not developed and implemented an adequate system of internal controls over many aspects of its operations. Specifically, we found that Riverside did not properly document its accounting system; did not adequately segregate the duties of its administrative staff; did not maintain all of its records in accordance with state regulations; failed to establish an effective inventory system for its fixed assets, which as of June 30, 2003 totaled $355,468; and did not maintain its accounting records in accordance with GAAP. As a result, the Commonwealth cannot be assured that public funds were properly safeguarded against misuse and expended for their intended purposes, or that all of Riverside's transactions were properly authorized, recorded, and reported. In its response, Riverside acknowledges that it needs to develop policies and procedures regarding its accounting function and is in the process of doing so. We believe that such measures are necessary.

In its response, Riverside further contends that the reason for its lack of establishing controls was that it was focused on providing quality educational services at a reasonable rate. However, clearly Riverside is required by state regulations and the terms and conditions of its state

contracts to establish adequate controls over all of its activities as well as provide the contracted program services. The costs of poor controls typically result in problems such as inefficient and ineffective management practices and the loss and/or misuse of funds. In fact, we question how an organization such as Riverside can ensure that it does provide quality services at reasonable rates without implementing controls to ensure that all agency transactions are properly authorized, recorded and reported and that all expenses are reasonable and allowable. It is important to note that the vast majority of human service providers we have audited have been able to establish efficient and effective internal controls over their operations while at the same time provide quality services to their clients. The fact that the agency may have grown in size over the years does not mitigate its responsibility to ensure that adequate controls are in place to protect the Commonwealth's funds.

Regarding the segregation of duties, it is Riverside's management's responsibility to establish effective controls over the agency's operations, including making sure that there is a proper segregation of duties. This is particularly important when all the key functions of an organization are being conducted by two employees who are husband and wife. If Riverside did not want to hire additional full-time staff, it should have implemented other compensating controls, such as hiring part time consultants to perform certain activities such as reconciling the agency's bank statements, which would have added some independence to the agency's accounting system. In our opinion, it is not a prudent management decision to be more "efficient" at the expense of not properly safeguarding an entity's assets.

SUBSEQUENT EVENTS

Subsequent to the conclusion of our audit fieldwork at Riverside, the following significant events took place:

1. On July 1, 2004, Riverside sold "its operating assets, i.e., furniture and equipment, materials and supplies" and assigned its "rights in…funding agreements, equipment leases and the name "Riverside School" to NFI Massachusetts, Inc. (NFI).

2. The Executive Director stated that on June 30, 2004, IAL terminated its facility leases with Riverside, a related party, and then leased them to NFI, commencing on July 1, 2004.

3. Per the April 29, 2004 sale agreement obtained from the Executive Director between NFI and IAL, effective July 1, 2004, the owner of IAL has agreed to

reimburse Riverside $300,000 for leasehold improvement expenditures it had incurred relating to the facilities it had leased from IAL. The payment is set at $50,000 per year with an interest rate of 6% rate per annum.

4. On June 1, 2004, Riverside's Bookkeeper submitted her resignation effective June 30, 2004.

5. On July 1, 2004, Riverside's Executive Director became a part-time consultant to NFI per a consulting agreement dated April 8, 2004 (three weeks before Riverside was sold to NFI). This consultant agreement indicates that he will receive $125/hour for a minimum of 1,000 hours per year or $125,000 per year for the next five years, with the option to renew, for a total of $625,000.

6. On July 1, 2004, IAL (owned by Riverside's Executive Director) per lease agreement**,** will lease to NFI all of its properties over a minimum of five years for at least $315,000 per year ($1,575,000). NFI will also pay real estate taxes, utilities, and general property upkeep expenses.

7. We obtained and reviewed General Ledger expenditures, which had not been audited, from April 1, 2004 through June 30, 2004, and noted the following questionable expenditures, totaling $128,412:

   a. Bimonthly payroll amounts for the month of June 2004 increased significantly, from $109,423 to $165,470 or $56,047. As noted in Audit Result No. 5, Riverside routinely issues bonuses to employees during the month of June.

   b. The following staff training "reimbursements" were noted:

Date	Payee	Check Number	Amount
4/12/04	MAAPS	11788	$ 1,500
4/22/04	MAAPS	11804	1,017
4/28/04	Cambridge College	11818	3,150
5/10/04	Cambridge College	11863	13,450
5/12/04	Cambridge College	11876	3,650
5/13/04	Cambridge College	11882	3,650
Totals			$26,417

Staff training costs such as these are nonreimbursable (see Audit Result No. 5) because Riverside does not have formal written procedures for providing such reimbursements. Riverside routinely pays for courses for employees before the course begins, and does not require documentation to support that such courses were properly completed.

c. A variety of large payments were made, totaling $45,948. These expenditures included an $800 donation, $22,483 for repairs and maintenance, and $22,665 for furniture replacement.