Commonwealth of Massachusetts
Office of the State Auditor
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Making government work better

Official Audit Report – Issued October 26, 2012

Certain State Agencies' Compliance with the Operational Service Division's Audit Resolution Policy

For the period April 5, 2005 through March 31, 2011

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INTRODUCTION AND SUMMARY OF FINDINGS AND RECOMMENDATIONS

Human service providers doing business with state agencies are subject to audits conducted by various organizations, including private accounting firms and the Office of the State Auditor (OSA). To ensure that any problems identified during those audits are expeditiously and effectively resolved, the Operational Services Division (OSD), the state agency responsible for regulating and overseeing the activities of the state's contracted human service providers, has issued the "Audit Resolution Policy for Human and Social Services." This policy details procedures for use by state agencies and contracted human service providers to address the findings and recommendations in auditors' reports issued in accordance with generally accepted government auditing standards.

In accordance with Chapter 11, Section 12, of the Massachusetts General Laws, the OSA conducted a performance audit of certain state agencies' compliance with OSD's Audit Resolution Policy. The specific state agencies audited include five agencies that fall within the state's Executive Office of Health and Human Services (EOHHS)—the Department of Children and Families (DCF), the Department of Mental Health (DMH), the Department of Developmental Services (DDS), the Department of Transitional Assistance (DTA), and the Massachusetts Rehabilitation Commission (MRC)—and two other state agencies: the Department of Elementary and Secondary Education (DESE) and the Department of Early Education and Care (EEC).

The objectives of our audit, which covered the period April 5, 2005 through March 31, 2011, included an assessment of the measures taken by state agencies to address the issues raised in our prior audit (No. 2006-5120-15C), the measures state agencies have taken to ensure their compliance with OSD's Audit Resolution Policy relative to audits conducted by the OSA during our current audit period, and the overall effectiveness of OSD's audit resolution process.

In order to ensure the proper resolution of all problems identified during OSA audits, it is essential that OSD administer an effective audit resolution process and that state agencies that purchase human services continue to take the measures necessary to ensure that they fully comply with this process.

Highlight of Audit Findings

Our follow-up review disclosed the following:

- State human service agencies have taken measures to address concerns raised by the OSA in its previous audit in this area by implementing more effective internal controls to ensure compliance with OSD's Audit Resolution Policy. As a result, these agencies have resolved over $3.5 million in disallowed expenses identified during OSA audits issued during our current audit period.

- OSD's policy allows providers to resolve audit findings in which they have been found to have charged the Commonwealth for nonreimbursable expenses by filing amended financial statements with OSD retroactively showing that other available non-state funds were used to pay for these nonreimbursable expenses rather than by reimbursing the Commonwealth directly. Our current audit revealed that this policy resulted in $2,610,660 in nonreimbursable expenses being resolved by allowing providers to make retroactive adjustments to their financial statements rather than the Commonwealth's actually recouping these funds. This policy removes accountability from the system by creating a disincentive for providers to properly identify and account for their nonreimbursable expenses as required by state regulations and increases the risk that Commonwealth funds are being expended improperly.

Recommendations of the State Auditor

- OSD should continue to work with state human service agencies in ensuring that all issues identified during OSA audits are resolved in a manner consistent with OSD's Audit Resolution Policy.

- OSD should consider changing its current policy to require providers to reimburse the Commonwealth for any nonreimbursable expenses identified through audits.

Agency Progress

Our audit identified that the state agencies covered by our review have taken measures to address the issues identified during our prior audit by implementing more effective controls in this area. For example, EOHHS has established an Audit Resolution Oversight Policy that requires EOHHS agencies to follow specific, internally developed procedures in resolving issues identified during OSA audits in accordance with the Audit Resolution Policy. We believe that the policy and procedural changes that these state agencies have implemented will serve to better ensure their full compliance with OSD's Audit Resolution Policy.

OVERVIEW OF AUDITED AGENCY

The Operational Services Division (OSD), the state agency responsible for overseeing and regulating the activities of all contracted human service providers, pursuant to 808 Code of Massachusetts Regulations (CMR) 1.04 (10), issued its "Audit Resolution Policy for Human and Social Services," which details procedures for use by departments and contractors to address the findings and recommendations in independent auditors' reports issued in accordance with generally accepted government auditing standards (GAGAS).

When the OSA issues an audit report, a copy is sent to the audited contractor (auditee), the funding agencies, OSD, and other interested parties. Pursuant to OSD's Audit Resolution Policy, in order resolve any problems identified in these reports, an auditee must collaborate with its state purchasing agency and prepare, in accordance with the requirements of OSD's Audit Resolution Policy, a written Corrective Action Plan (CAP) approved by its Board of Directors. This CAP must be submitted to the auditee's Principal Purchasing Agency (PPA). According to OSD's Audit Resolution Policy, the CAP must address all audit findings, deficiencies, and uncorrected findings of prior audits; use reference numbers utilized by the OSA to identify the deficiencies; and specify corrective actions that the provider will take to address the deficiencies and the dates by which it will implement those actions.

Within six months of receiving the audit report and the CAP, the auditee's PPA must issue a management decision on the findings and recommendations of the audit report, as well as on the auditee's proposed CAP. The CAP is not officially complete and cannot be accepted by OSD until the PPA's management has evaluated and approved the auditee's proposed corrective actions for resolving the identified deficiencies. The original CAP and the written management decision are combined into an Administrative Agreement, which is signed by the authorized representatives of the human service provider and its PPA. A copy of this document is then forwarded to OSD and the appropriate state secretariat. OSD's Audit Resolution Policy states that the PPA must issue its management decisions as quickly as possible.

On October 31, 2006, the OSA issued an audit report (No. 2006-5120-15C) titled "Independent State Auditor's Report on Certain State Agencies' Compliance with the State Operational Services Division's Audit Resolution Policy." The scope of that audit was to determine the status of corrective actions taken by state agencies regarding deficiencies identified in the 33 audit reports[1] relative to the activities of 38 contracted human service providers issued by the OSA between April 1, 2001 and April 4, 2005. These audits identified 157 deficiencies involving $51,422,065 in state funds and recommended numerous corrective measures, including the recoupment of as much as $22,307,280 in state funds. We found that for the 38 human service providers included in this audit, state agencies implemented CAPs or took other measures, such as referring the audit to law enforcement agencies, for only nine of the 38 providers. Moreover, for the remaining 29 providers, we found numerous problems, such as two instances in which state agencies reduced the OSA's recommended recoupment amounts by $657,306 without the knowledge or approval of OSD and 11 instances in which state agencies did not negotiate the required CAPs, resulting in up to $1,751,196 not being repaid to the Commonwealth.

As a result of the deficiencies identified in our previous audit, we conducted a follow-up audit to assess the status of the problems we identified during our prior audit and to evaluate the measures taken by state purchasing agencies to better ensure their compliance with OSD's Audit Resolution Policy.

[1] One of the audits in this review (No. 2002-5086-3C) was a statewide audit of the state's Salary Reserve Program at multiple contracted human service providers. As a result of this audit, CAPs needed to be implemented with six human service providers, which brings the total number of CAPs for the 33 audits to 38.

AUDIT SCOPE, OBJECTIVES, AND METHODOLOGY

In accordance with Chapter 11, Section 12, of the General Laws, the Office of the State Auditor (OSA) has conducted a performance audit of certain state agencies' compliance with the Operational Services Division's (OSD) Audit Resolution Policy for the period April 5, 2005 through March 31, 2011. The OSA conducted this audit in accordance with generally accepted government auditing standards (GAGAS), which define performance audits as:

> *Engagements that provide assurance or conclusions based on an evaluation of sufficient, appropriate evidence against stated criteria, such as specific requirements, measures, or defined business practices. Performance audits provide objective analysis so that management and those charged with governance and oversight can use the information to improve program performance and operations . . . .*

GAGAS require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The specific state agencies audited include five agencies that fall within the state's Executive Office of Health and Human Services (EOHHS)—the Department of Children and Families (DCF), the Department of Mental Health (DMH), the Department of Developmental Services (DDS), the Department of Transitional Assistance (DTA), and the Massachusetts Rehabilitation Commission (MRC)—and two other state agencies: the Department of Elementary and Secondary Education (DESE) and the Department of Early Education and Care (EEC). The scope of our audit was to determine the extent to which these state agencies were complying with OSD's Audit Resolution Policy. Our audit objectives included an assessment of:

- The status of the measures taken by state agencies to address the issues raised in our prior audit on this subject (No. 2006-5120-15C);
- The measures taken, if any, by state agencies to ensure their compliance with OSD's Audit Resolution Policy relative to audits conducted by the OSA during our current audit period; and
- The overall effectiveness of OSD's audit resolution process.

To achieve our objectives, we first spoke with OSD officials and reviewed OSD's Audit Resolution Policy to obtain a current understanding of OSD's audit resolution process and the controls over this process. We then obtained OSD documentation detailing the status of the issues we identified in our prior audit as well as the 27 vendor audit reports issued by the OSA during our current audit period (April 5, 2005 through March 31, 2011). We reviewed this documentation and spoke with officials from applicable state agencies to determine the measures that those agencies have taken to ensure that CAPs are being fully implemented in accordance with OSD's Audit Resolution Policy.

AUDIT FINDINGS

1. PRIOR AUDIT RESULT RESOLVED - STATE AGENCIES HAVE TAKEN MEASURES TO ENSURE COMPLIANCE WITH OSD'S AUDIT RESOLUTION POLICY AND HAVE ADDRESSED THE RESOLUTION OF OVER $3.5 MILLION IN DISALLOWED STATE EXPENSES IDENTIFIED DURING AUDITS CONDUCTED BY THE OSA

During our prior audit (No. 2006-5120-15C), the Office of the State Auditor (OSA) found that the eight state agencies reviewed had not established adequate controls to ensure compliance with the Operational Services Division's (OSD) Audit Resolution Policy.[2] For example, only one of the eight state agencies reviewed in the prior audit had developed and implemented adequate formal written policies and procedures relative to compliance with the policy. The system-wide lack of formal written policies and procedures in this area resulted in state agency noncompliance with OSD's Audit Resolution Policy and problems identified through OSA audits involving millions of dollars in state funding not being resolved. During our follow-up review, we found that these state agencies have taken measures to address the issues we identified during our prior audit and have implemented more effective controls in this area. For example, the Executive Office of Health and Human Services (EOHHS) has established an Audit Resolution Oversight Policy that requires EOHHS agencies to follow specific, internally developed procedures in resolving issues identified during OSA audits in accordance with OSD's Audit Resolution Policy. As a result, our follow-up review found that the state agencies reviewed were in compliance with OSD's Audit Resolution Policy and had taken measures to address the resolution of over $3.5 million in disallowed costs identified as a result of OSA audits.

As noted in the Overview of Audited Agency section of this report, on October 31, 2006, the OSA issued an audit report (No. 2006-5120-15C) titled "Independent State Auditor's Report on Certain State Agencies' Compliance with the State Operational Services Division's Audit Resolution Policy." The scope of that audit was to determine the status of corrective actions taken by state agencies regarding deficiencies identified in the 33 audit reports relative to the activities of 38 contracted human service providers issued by the OSA between April 1, 2001 and April 4, 2005. This audit identified a number of problems, including that 11 of the 33 audits (33%) did not have the required negotiated Corrective Action Plan (CAP) and that, for two audits that had CAPs, state agencies reduced the OSA-recommended recoupment amounts

[2] OSD's Audit Resolution Policy details procedures for use by departments and contractors to address the findings and recommendations in independent auditors' reports issued in accordance with generally accepted government auditing standards.

without the knowledge or approval of OSD. As a result, at least $2,408,502 in state funding was not repaid to the Commonwealth, and numerous other internal control deficiencies went uncorrected.

During our follow-up review, the OSA determined that state agencies have either properly implemented CAPs or have taken other measures, such as referring the audits to law enforcement agencies, for all but three of the audits included in our prior audit. For the three remaining audits (No. 2003-4190-3C, No. 2001-4429-3, and No. 2003-4466-3C), many of the individual issues identified in these audits have been resolved; however, due to various circumstances, the CAPs for these audits were still being finalized. For example, the Department of Developmental Services (DDS) no longer contracts with one of these three providers, South Shore Mental Health, Inc. (No. 2003-4190-3C), but is in the process of finalizing an agreement under which this provider will continue to provide free care services totaling $136,586 to consumers referred by the Commonwealth in order to resolve the issues identified during an OSA audit.

During our follow-up review, we first assessed what internal controls, if any, state agencies have established to ensure compliance with OSD's Audit Resolution Policy since our last audit. In this regard, we found that in July 2005, EOHHS established a Purchase of Service (POS) Integrity Unit to track all CAP activities relative to OSA audits until all corrective measures have been fully implemented. Also, EOHHS officials stated that all agencies within EOHHS have designated an audit resolution liaison who is part of a committee that meets quarterly to report on the status of any special areas of risk, changes in policy and/or procedures, or other concerns regarding audit resolution. Further, in September 2008, EOHHS established an "Audit Resolution Oversight Policy for OSA Audits" that details specific policies and procedures that EOHHS agencies must follow to ensure compliance with OSD's Audit Resolution Policy. This EOHHS policy also establishes direct oversight by the POS Integrity Unit of all human services agencies' audit resolution and CAP activities, ensuring that purchasing agency policies and procedures are in place and that resolution activities are tracked and brought to successful conclusion in accordance with OSA recommendations and OSD's Audit Resolution Policy.

Additionally, we found that the Department of Early Education and Care (EEC) has also established a set of policies and procedures regarding resolution of OSA audit findings in its

"Audit Compliance & Resolution Unit Fiscal Monitoring Manual." These policies and procedures require compliance with OSD's Audit Resolution Policy and state that EEC will recover improper payments made to providers. These policies and procedures also provide for the monitoring of the resolution process by EEC's Director of Audit Compliance & Resolution and its fiscal monitoring staff. Further, according to EEC's Director of Compliance & Audit Resolution, EEC initiates its own follow-up audits of human service providers in those instances in which the OSA has conducted an audit and has identified issues.

In order to assess the adequacy of the aforementioned controls implemented by state agencies, we reviewed the status of the recommendations made by the OSA in 27 human service provider audits issued since our last report, between April 5, 2005 and March 31, 2011. In these 27 audits, the OSA identified deficiencies involving $25,942,595 in funds. Of these 27 audits, only two audits—Montachusett Opportunity Council, Inc., (No. 2010-4203-3C) and New England Human Services, Inc., D/B/A Riverside School (No. 2004-4484-3C)—did not have completed CAPs because both vendors were referred to law enforcement agencies for further investigation and resolution. For the remaining 25 audits, the OSA identified issues relative to $24,020,078 in funds involving various problems, such as poor internal controls, inefficient program management, contract nonperformance, and expenditures that were nonreimbursable in accordance with OSD regulations. It should be noted that, in many instances, the OSA audits identified funds that were at risk for loss, theft, or misuse in addition to expenditures that were actually deemed to be unallowable. Consequently, in those instances, rather than requiring the reimbursement of the funds involved, it was more reasonable and appropriate to recommend that the human service providers implement more effective internal controls and management practices to preclude any misuse of the funds in question. However, in these 25 audits, the OSA, in collaboration with state purchasing agencies, identified $3,587,021 in state funding that was subject to recoupment by the Commonwealth, as detailed in the following table:

Name of Vendor	Principal State Funding Agency	Disallowed Costs
Amego, Inc.	DDS	$27,130
Center for School Crisis Intervention and Assessment, Inc.	DOE	162,020
Child Development Family Systems, Inc.	EEC	-
Clarendon Family Day Care, Inc.	EEC	92,554
Commonwealth Family Childcare, Inc.	EEC	72,000
Cooperative Production, Inc.	DDS	49,208
Crittenton, Inc.	DTA	35,506
Frederic L. Chamberlain Center, Inc.	DMH	176,007
Goodwill Industries, Inc. of Springfield	DDS	100,105
GROW Associates, Inc.	DDS	10,773
Habilitation Assistance Corporation	MRC	-
Hawthorn Services Incorporated	DMH	7,551
Human Resources Unlimited	DMH	92,504
Human Service Options, Inc.	DDS	67,909
Integrated Clinical Solutions, Inc.	DDS	49,061
Kiddie Kampus, Inc.	EEC	327,708
L.P. College, Inc.	EEC	144,436
LifeLinks, Inc.	DDS	286,661
Little People's College, Inc.	EEC	48,259
Middlesex Human Service Agency, Inc.	DPH	37,949
Rainbow Child Development Center, Inc.	EEC	-
Road To Responsibility, Inc.	DDS	789,624
Seven Hills Foundation	DDS	-
The Kids Place, Inc.	EEC	112,642
Valley Educational Associates, Inc.	DOE	897,414
Total		$3,587,021

Based on our audit testing in this area, we determined that, for 23 of the 25 audits, state agencies implemented CAPs in full compliance with OSD's Audit Resolution Policy. In the other two instances, we found that state agencies agreed to recover amounts that were, in total, $151,921 less than that recommended by the OSA. However, in those two instances, there were formal written settlement agreements that detailed why the reductions were made, which were signed off by the state funding agency, the provider, and OSD as being an acceptable resolution.

Recommendation

OSD should continue to work with state human service agencies in ensuring that all issues identified during OSA audits are resolved in a manner consistent with OSD's Audit Resolution Policy.

Auditee's Response

In response, OSD's Assistant Secretary for Operational Services provided the following comments:

> *We are pleased that the draft audit report Audit Result #1 found that prior audit results (OSA Audit No. 2006-5120-15C) were resolved and that state agencies have taken the necessary measures to ensure compliance with OSD's Audit Resolution Policy (ARP). The draft report also states that your follow-up review of these prior audits found that state agencies had taken measures to address the resolution of over $3.5 million in "disallowed" costs identified as a result of OSA audits. This finding provides encouragement for our efforts in the area of Purchase of Service auditing and reflects the positive results for the Commonwealth of OSA's and OSD's work in this area.*

2. OSD'S POLICY OF ALLOWING HUMAN SERVICE PROVIDERS TO FILE AMENDED FINANCIAL STATEMENTS TO ADDRESS THE ISSUE OF NONREIMBURSABLE EXPENSES REMOVES A LEVEL OF ACCOUNTABILITY FROM ITS SYSTEM OF OVERSIGHT OVER PROVIDER BILLINGS

OSD's Audit Resolution Policy establishes specific resolution standards with which state agencies must comply when developing CAPs to address issues identified in OSA audits. In terms of nonreimbursable expenses, these standards state that these expenses are subject to recovery through recoupment, delivery of in-kind services, or rate adjustment. However, before requiring human service providers to repay any expenses that audits have identified as nonreimbursable, OSD has adopted a policy of allowing providers that receive sufficient non-state contract revenues to adjust and refile the financial statements they previously submitted to OSD to show that non-state funds were used to pay for these nonreimbursable expenses, instead of seeking reimbursement of these funds. For the reports included in our current audit period, this resulted in $2,610,660 in nonreimbursable expenses being resolved through accounting adjustments rather than actual recovery. The lack of financial consequences for all human service providers that fail to properly report nonreimbursable expenses that were subsequently identified in OSA audits creates a disincentive for providers to vigilantly identify and report all of their nonreimbursable expenses, and removes a level of accountability for the system of oversight over provider billings. Only those providers that are subject to an audit and are found to have charged the Commonwealth for nonreimbursable expenses are required to go back and identify non-state funds used to pay for nonreimbursable expenses, thereby removing any deterrent value that the system could provide in order to protect the Commonwealth from paying other providers for these expenses. The U.S. Government Accountability Office (GAO) has recognized the importance of deterrence in an effective system of oversight over government contractors. In a 1993 report entitled DOD's Use of the Truth in Negotiations Act Deterrents Could Be Increased, the GAO stated:

> *Without adequate deterrence, contractors and subcontractors do not have incentive to eliminate inflated price estimates and correct systemic pricing problems. In addition, the costly and burdensome process of identifying and settling defective pricing by the government and contractors will continue.*

OSD should consider amending its policy of allowing human service providers that have been found through OSA audits to have charged nonreimbursable costs against their state contracts to resolve these issues in this manner. An amended policy that encourages human service providers to be more vigilant in identifying and reporting all of their nonreimbursable expenses and provides consequences for the failure to do so would bring greater accountability over provider billings and, based on the results of our review, could result in millions of dollars in savings to the Commonwealth.

As previously noted, OSD's Audit Resolution Policy establishes certain standards that state human service agencies must follow when developing CAPs to resolve problems identified in OSA audits of human service providers. These standards describe the nature of each type of unallowable expense (e.g., contract nonperformance, fraudulent billings, undocumented expenses, billing errors, improper staffing levels, overbillings, billings for nonreimbursable expenses) and the method that must be followed by state agencies in the resolution of each type of problem. In terms of nonreimbursable expenses, these standards state:

> *Under all contracts, reimbursement to Contractors is permitted only for actual reimbursable operating costs incurred (as defined in 808 CMR 1.02) for the contract, based on terms of the contract, Division of Health Care Finance and Policy requirements, and/or purchasing Department requirements.*

Further, OSD's Audit Resolution Policy identifies the following resolution standard for nonreimbursable expenses:

> *D. <u>Non-Reimbursable Expenses</u>*
>
> *Non-reimbursable costs (as defined in 808 CMR 1.05) that are defrayed using Commonwealth funds and offsetting revenue (intended for use in defraying reimbursable costs), as designated in the contract or as required by 808 CMR 1.00 or OMB Circular A-110 (program income as applicable), are subject to recovery through recoupment, delivery of in-kind services or rate adjustment, in accordance with 808 CMR 1.05.*

OSD's standard for the resolution for any identified nonreimbursable expenses charged against state contracts is to recover these amounts using several different measures (e.g., recoupment of funds, provision of additional in-kind services, rate adjustment). In practice, however, OSD has a different method for resolving these deficiencies. Specifically, before determining the amount of expenses to be recovered, OSD allows these providers to adjust and refile their Uniform Financial Statements and Independent Auditor's Report (UFR) to show that non-state funds were used to pay for these unallowable expenses rather than requiring the reimbursement of these funds.

The 27 audit reports of human services providers issued by the OSA during our audit period found 111 deficiencies, including 51 that identified a total of $8,230,941 in what the OSA classified as nonreimbursable expenses. For these 51 deficiencies, the OSA, in collaboration with state purchasing agencies, disallowed $3,246,574 in nonreimbursable expenses. However, for the majority of these issues, OSD allowed the human service providers to adjust and refile their UFRs to show that non-state revenues were used to pay for these nonreimbursable expenses. Specifically, providers were allowed to avoid repaying $2,610,660 of the $3,246,574 in nonreimbursable expenses disallowed by adjusting and refiling their UFRs.

OSD should consider changing its policy and not allow providers to mitigate repayment of nonreimbursable expenses identified through OSA audits by simply refiling UFRs for several reasons. First, in purchasing human services, the Commonwealth is not permitted to pay for costs that have been identified in 808 Code of Massachusetts Regulations (CMR) 1.05 (1) through (27) as nonreimbursable costs. Consequently, contracted human service providers are given two opportunities to disclose any nonreimbursable expenses that they can anticipate and/or did not anticipate but actually incurred in the operation of their state-funded programs. In order to account for anticipated nonreimbursable expenses, when negotiating contracts for program services, OSD contract provisions require human service providers to identify all anticipated nonreimbursable expenses in their negotiated program budgets and also identify all sources of non-state revenues that will be used to pay for these nonreimbursable expenses. This procedure ensures that no nonreimbursable expenses are included in the development of each program's budget and ultimately in the calculation of the amount of funding that the state agency must provide to the human service provider to operate the program. Since the contract negotiation process provides for the accounting of all anticipated nonreimbursable expenses, any nonreimbursable expenses that are identified during an audit as being charged against a state-funded program contract that were not considered in the development of the program budget are clearly inappropriate charges and therefore should represent recoverable expenses. This is consistent with guidance issued by OSD in its UFR Audit and Preparation Manual, which states, in part:

> *The existence of non-reimbursable costs, as contained in 808 CMR 105 (Effective 2/1/97, 808 CMR 105) 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 . . . .*

Second, OSD allows providers to report any unanticipated nonreimbursable costs incurred in the development of their program budgets and identify the sources of non-state funds that were used to pay for these nonreimbursable expenses in the UFRs filed annually with OSD. When providers initially file their UFRs with OSD, most of the financial information in the UFR, including the disclosure of all nonreimbursable expense amounts, has been independently audited and reported to be complete and accurate, not only by the providers' audit firm but also by the providers' Board of Directors, which signs under the pain and penalties of perjury that the information in the report is accurate. Consequently, allowing providers to amend their UFRs for the purposes of showing that non-state funds were used to pay for nonreimbursable expenses (in most cases several years after the original UFR has been audited and submitted to

OSD) creates a disincentive for providers to be vigilant about tracking and disclosing all nonreimbursable expenses, since there are no financial consequences for not reporting these expenses in accordance with OSD and state contracting guidelines. Finally, allowing providers to adjust and refile their financial information creates discrepancies between the providers' financial statements and financial records. Specifically, the providers' UFRs when adjusted for this purpose will show that non-state revenues were used to pay for the identified nonreimbursable expenses, whereas the providers' accounting records will continue to show these expenses as charged to state contracts.

During our audit, we discussed this matter with OSD's Director of Audit and Compliance, who provided the following comments:

> *OSD provides the option of refiling the UFR as a practical step for providers to correct submissions prior to initiating recovery where a determination of the liability for non-reimbursable costs cannot be made until a UFR refiling has been submitted and reviewed to determine if appropriate non-Commonwealth funds were in fact available to offset non-reimbursable costs but not disclosed as such in the initial UFR filing. In cases where non-Commonwealth funds are identified in the refiling and are sufficient to offset identified non-reimbursable costs, there is no liability to recover. I believe the practicality of this approach is why the Office of the State Auditor (OSA) readily acknowledges that some of its own audit reports recommended the refiling of the UFR as an appropriate resolution of cited non-reimbursable costs and that to my knowledge OSA has not routinely challenged an auditee's response indicating a UFR refiling will be submitted to OSD as a resolution of a non-reimbursable cost finding.*
>
> *As noted above, a refiling to properly report non-reimbursable costs and appropriate non-Commonwealth revenue available to offset non-reimbursable costs is a practical step prior to initiating recovery efforts. Upon review of the refiled UFR, OSD makes a determination regarding the liability to the Commonwealth for non-reimbursable costs reported in Commonwealth-funded programs where sufficient non-Commonwealth funds are not available as offset. If the refiled UFR provides credible evidence that Commonwealth funds were not used to offset non-reimbursable cost the refiled UFR would represent an acceptable resolution of a non-reimbursable cost finding.*

When asked whether he believed that allowing human service providers to refile their UFRs to address unreported nonreimbursable expenses that were identified during OSA audits gave providers a means of circumventing OSD regulations, OSD's Director of Audit and Compliance provided the following comments:

> *Based on the procedures OSD has in place regarding its refiling policy, as explained above, we don't believe modifications are currently warranted.*

Recommendation

OSD should reevaluate its practice of allowing vendors to adjust and refile their UFRs rather than reimburse the Commonwealth directly for any nonreimbursable expenses identified during OSA audits.

Auditee's Response

In response to this issue, the Assistant Secretary for OSD stated, in part:

> *This finding does not accurately reflect OSD's Audit Resolution Policy or its practices with respect to the recovery of nonreimbursable costs.*
>
> *Elsewhere in the Draft Report, OSA attributes to OSD, a policy which "allows human service providers that have sufficient non-state contract revenues to address any nonreimbursable expenses identified during OSA audits, by re-filing the financial statements they submit to OSD <u>to show</u> that non-state funds were used to pay for these unallowable expenses as opposed to requesting reimbursement of these funds.". . .*
>
> *As noted in the Draft Report, OSD's Audit Resolution Policy addresses the standard for resolving nonreimbursable expenses:*
>
>> *D. Non-Reimbursable Expenses*
>>
>> *Non-reimbursable costs (as defined in 808 CMR 1.05) <u>that are defrayed using Commonwealth funds and offsetting revenue (intended for use in defraying reimbursable costs)</u>, as designated in the contract or as required by 808 CMR 1.00 or OMB Circular A-110 (program income as applicable), are subject to recovery through recoupment, delivery of in-kind services or rate adjustment. (emphasis added)*
>
> *In accordance with this policy, OSD's first step in the resolution of nonreimbursable costs must be the determination of whether the nonreimbursable costs are subject to recovery. The (former) OSD Director of Audit and Quality Assurance in an email . . . [to the OSA], explained as follows:*
>
>> *OSD provides guidance in the UFR Audit and Preparation Manual specifically covering the <u>refiling</u> of the UFR <u>relative to identifying non-Commonwealth revenue to offset non-reimbursable costs</u>. A key component of the non-reimbursable cost policy is the determination that non-reimbursable costs are defrayed with Commonwealth funds. OSD provides the option of refiling the UFR as a practical step for providers to correct submissions <u>prior to initiating recovery</u> where a determination of the liability for non-reimbursable costs cannot be made until a UFR refiling has been submitted and reviewed to determine if appropriate non-Commonwealth funds were in fact available to offset non-reimbursable costs but not disclosed as such in the initial UFR filing. In cases where non-Commonwealth funds are identified in the refiling and are sufficient to offset identified non-reimbursable costs, there is no liability to recover. (emphasis in original)*

The purpose of the refiling, therefore, is to determine whether there is in fact a liability to the Commonwealth. As stated above, OSD provides the option of refiling the UFR only when the determination of liability cannot be made without a refiling. This procedure allows OSD to identify the amount "subject to recovery through recoupment, delivery of in-kind services or rate adjustment."

OSD does not believe that the refiling of the UFR alone is an acceptable resolution of an OSA audit finding relative to identified nonreimbursable costs.

The refiled UFRs submitted to resolve non-reimbursable cost audit findings are desk reviewed by OSD audit staff and, when there is reasonable doubt whether the sources of non-Commonwealth funds reported are applicable for offsetting reported non-reimbursable costs, OSD requests additional detailed information from the filer regarding the applied funding sources to determine if those sources of funding are available and applicable for offsetting non-reimbursable costs. If upon review of the refiled UFR and any responses from the filer to our requests for additional information OSD is not thoroughly convinced that the non-reimbursable costs were properly offset with non-Commonwealth funding, OSD would oversee the process to ensure an appropriate corrective action plan calling for recovery is negotiated with the contractor and its Principal Purchasing Agency (PPA).

OSD's Audit Resolution Policy and practices regarding the resolution of nonreimbursable costs are both sound and efficient. OSD identifies the amount subject to recovery and proceeds with the recovery process. The Draft Report suggests that the request for reimbursement should precede the determination of the amount to be recovered. This would result in the request for the return of funds that are not subject to recovery and potentially the recoupment of non-Commonwealth funds that were used to pay for nonreimbursable expenses.

For the above reasons, we are requesting that OSA not include Result #2 in the final audit report on this matter. We agree that increased vigilance on the part of human service vendors in identifying and reporting all of their nonreimbursable expenses is a laudable goal. Yet we do not believe the disruption of the policies and procedures of OSD, as indicated in the Draft Report, is a fertile path to this goal.

Auditor's Reply

Contrary to OSD's assertion, the information presented in our report accurately reflects OSD's Audit Resolution Policy and its practices with respect to the recovery of nonreimbursable costs, as well as the comments made by OSD's former Director of Audit and Quality Assurance regarding why OSD allows human service providers to adjust and refile their UFRs. We acknowledge that OSD allows contracted human service providers that have sufficient non-state revenues to refile their UFRs and that, based on its review of the refilings, OSD determines whether any nonreimbursable expenses that were identified during OSA audits are recoverable. However, the OSA does not view this policy to be, as OSD states, an opportunity to "correct submissions" in provider UFRs but rather as an opportunity for providers that have charged nonreimbursable expenses against their state contracts to mitigate having to refund any of these funds to the Commonwealth. This policy was applied to the vast majority of the reports included in this audit, which resulted in providers being allowed to avoid repaying $2,610,660 of the $3,246,574 in nonreimbursable expenses by adjusting and refiling their UFRs for expenses that were disallowed. OSD further states, "The purpose of the refiling, therefore, is to determine whether there is in fact a liability to the Commonwealth." However, the OSA believes that the fact that the provider has already filed a UFR that has been audited and approved by its Board of Directors as being true and accurate that shows that nonreimbursable expenses were charged to state contracts is sufficient to establish a liability of the provider for the repayment of these nonreimbursable funds to the Commonwealth.

In its response, OSD correctly points out that in some prior audits of human services providers, the OSA has recommended that human service providers amend their UFRs rather than pay back the nonreimbursable expenses that were identified during the audit. The OSA did this in order to make a recommendation to the provider and OSD that was consistent with existing OSD's policy, under which, in those cases where the provider had sufficient non-state revenue, OSD would ultimately allow the provider to refile its UFRs to address this issue even if reimbursement was recommended by the OSA. However, this was in no way an acknowledgment that the OSA believed that this policy was the most appropriate and effective way to resolve this issue. Instead it was a function of the fact that OSD's Audit Resolution Policy itself was not being audited in those instances as it is here.

In its response, OSD correctly points out that its former Director of Audit and Quality Assurance stated that a key component of OSD's nonreimbursable cost policy is the determination that nonreimbursable costs are defrayed with Commonwealth funds. In this regard, during most of the period covered by this audit, OSD's Uniform Financial Statements and Independent Auditor's Report Audit and Preparation Manual stated, 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.*

According to this guidance, in cases where an audit has determined that a provider has failed to disclose its nonreimbursable expenses (either through the contract negotiation process or the filing of its annual UFRs), OSD presumes that state and federal funds were used to defray the expenses in question. Accordingly, OSD's Audit Resolution Policy states that such nonreimbursable costs are subject to recovery, as follows:

> *Non-reimbursable costs (as defined in 808 CMR 1.05) <u>that are defrayed using Commonwealth funds and offsetting revenue (intended for use in defraying reimbursable costs)</u>, as designated in the contract or as required by 808 CMR 1.00 or OMB Circular A-110 (program income as applicable), are subject to recovery through recoupment, delivery of in-kind services or rate adjustment.*

In the OSA's opinion, human service providers should be allowed to amend and refile their UFRs in instances where OSD identifies an error in the provider's filing or when, subsequent to the filing of a UFR, non-state funds become unrestricted and available for a provider to use for certain nonreimbursable expenses identified in the original UFR. However, allowing providers to simply adjust and refile UFRs to address the issue of nonreimbursable expenses identified during OSA audits may allow providers to retain state funds to which they are not entitled, and does not deter other providers from failing to identify and report these expenses at the outset.

As noted in our report, contracted human service providers are given two opportunities to disclose any nonreimbursable expenses that they can anticipate and/or did not anticipate but actually incurred in the operation of their state-funded programs. In order to account for anticipated nonreimbursable expenses, when negotiating contracts for program services, OSD contract provisions require human service providers to identify both all anticipated nonreimbursable expenses in their negotiated program budgets and all sources of non-state revenues that will be used to pay for these nonreimbursable expenses. This procedure ensures that no nonreimbursable expenses are included in the development of each program's budget and ultimately in the calculation of the amount of funding that the state agency must provide to the human service provider to operate the program. This contracting process, when utilized correctly, ensures that program prices are developed in a transparent manner, all involved parties understand in advance how resources will be used, and the resulting negotiated prices are not inflated by the inclusion of nonreimbursable expenses, which would result in the provision of more public funding than necessary for the specified program services. Because the contract negotiation process provides for the accounting of all anticipated nonreimbursable expenses, any nonreimbursable expenses that are identified during an audit as being charged against a state-funded program contract that were not considered in the development of the program budget are clearly inappropriate charges and therefore should represent recoverable expenses.

Further, OSD allows providers to report any nonreimbursable costs that they incurred but may not have anticipated in the development of their program budgets and identify the sources of non-state funds that were used to pay for these nonreimbursable expenses in the UFRs that they must file annually with OSD. Consequently, providers are obligated to establish accounting systems that effectively identify and disclose both budgeted and unanticipated nonreimbursable expenses.

The OSA continues to encourage OSD to reevaluate its practice of allowing vendors to adjust and refile their UFRs rather than reimburse the Commonwealth directly for any nonreimbursable expenses identified during OSA audits.

APPENDIX

Audit Reports Included in Current Audit

Audit No.	Name of Human Service Provider	Audit Period	Principal Purchasing Agent	Audit Report Issue Date
2009-4526-3C	Amego, Inc.	7/1/07-6/30/09	DDS	9/30/2010
2006-4502-3C	Center for School Crisis Intervention and Assessment, Inc.	9/1/04-8/31/06	DOE	1/24/2007
2005-4491-3C	Child Development Family Systems, Inc. (now Child Development Centers & Systems)	1/1/03-12/31/04	EEC	11/30/2005
2007-4432-3C	Clarendon Family Day Care, Inc.	10/1/04-8/31/07	EEC	12/13/2007
2006-4498-3C	Commonwealth Family Childcare, Inc.	7/1/04-5/31/06	EEC	5/2/2007
2005-4488-3C	Cooperative Production, Inc.	7/1/02-10/1/04	DDS	9/20/2005
2005-4489-3C	Crittenton, Inc.	7/1/03-2/28/05	DTA	8/11/2005
2006-4500-3C	Frederic L. Chamberlain Center, Inc.	9/1/03-8/31/06	DMH	3/18/2008
2005-4492-3C	Goodwill Industries, Inc. of Springfield	7/1/00-6/30/05	DDS	10/31/2005
2009-4478-3C	GROW Associates, Inc.	7/1/06-5/1/09	DDS	4/26/2010
2006-4496-3C	Habilitation Assistance Corporation	7/1/03-12/31/05	MRC	8/15/2006
2006-4283-3C	Hawthorn Services Incorporated	7/1/03-6/30/05	DMH	10/30/2006
2007-4284-3C	Human Resources Unlimited	7/1/01-6/30/06	DMH	12/2/2008

Audit No.	Name of Human Service Provider	Audit Period	Principal Purchasing Agent	Audit Report Issue Date
2004-4331-3C	Human Service Options, Inc.	7/1/01-3/31/04	DDS	10/12/2005
2005-4494-3C	Integrated Clinical Solutions, Inc.	1/1/03-9/30/05	DDS	6/8/2006
2007-4504-3C	Kiddie Kampus, Inc.	1/1/04-12/31/06	EEC	3/13/2008
2007-4506-3C	L.P. College, Inc.	1/1/04-6/30/07	EEC	3/11/2009
2008-4509-3C	LifeLinks, Inc.	7/1/04-2/29/08	DDS	10/15/2008
2007-4505-3C	Little People's College, Inc.	7/1/04-12/31/06	EEC	8/19/2008
2010-4542-3C	Middlesex Human Service Agency, Inc.	7/1/06-5/31/10	DPH	2/15/2011
2010-4203-3C	Montachusett Opportunity Council, Inc.	11/1/07-9/30/09	EEC	11/9/2010
2004-4484-3C	New England Human Services, Inc., D/B/A Riverside School	7/1/01-3/31/04	DSS	1/9/2006
2007-4186-3C	Rainbow Child Development Center, Inc.	7/1/04-6/30/06	EEC	7/12/2007
2008-4317-3C	Road To Responsibility, Inc.	7/1/04-12/31/07	DDS	1/30/2009
2005-4387-3C	Seven Hills Foundation, Inc.	7/1/03-12/31/04	DDS	8/3/2005
2007-4507-3C	The Kids Place, Inc.	1/1/05-12/31/06	EEC	2/14/2008
2006-4495-3C	Valley Educational Associates, Inc., D/B/A Valley West Day School.	7/1/02-6/30/05	DOE	5/1/2006