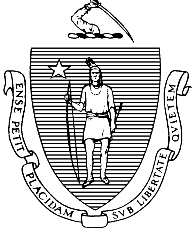

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INDEPENDENT STATE AUDITOR'S REPORT ON CERTAIN ACTIVITIES OF KIDDIE KAMPUS, INC.

JANUARY 1, 2004 TO DECEMBER 31, 2006

OFFICIAL AUDIT REPORT

MARCH 13, 2008

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Kiddie Kampus, Inc. (KKI), located in North Dartmouth, Massachusetts, was incorporated on August 25, 1989 as a private, non-sectarian, for-profit early childhood daycare center. KKI strives to foster a safe, nurturing environment that promotes the physical, social, emotional, and cognitive development of young children with programs that are designed for three different stages of development: infant/toddler, pre-school, and school-age children. KKI is currently licensed by the state's Department of Early Education and Care (EEC) to provide childcare services to 448 children that range in age from infants to 14 years old (131 infants and toddlers, 227 pre-schoolers, and 90 school-age children).

The scope of our audit was to examine various administrative and operational activities of KKI during the period January 1, 2004 to December 31, 2006. We conducted this audit in accordance with generally accepted government auditing standards for performance audits issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence that provides 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, in accordance with those standards.

Our audit procedures consisted of the following:

A determination of whether KKI had implemented effective internal controls, including:

- Processes for planning, organizing, directing, and controlling program operations.
- Policies and procedures to ensure that resource use is consistent with Massachusetts laws and regulations, and that resources are safeguarded and efficiently used.
- An assessment of KKI'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.

Our audit identified that during our audit period, KKI did not properly disclose the non-state revenues it used to pay for at least $720,097 in unallowable expenses, retained profits in excess of its negotiated commercial fee, charged unallowable vehicle expenses to the Commonwealth, did not properly disclose related-party transactions, did not properly document $1,531,710 in administrative payroll expenses, and did not establish adequate internal controls over certain aspects of its operations.

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According to OSD guidelines, agencies that incur expenses that are non-reimbursable under their state contract are required to identify their expenses as well as the sources of non-state revenue used to pay for these expenses in the financial reports they file with

the state's Operational Services Division (OSD), the agency responsible for regulating and overseeing the activities of contracted human service providers such as KKI. During fiscal years 2004 through 2006, KKI disclosed that it had incurred $720,097 in non-reimbursable expenses in the Uniform Financial Reports (UFRs) it filed with OSD. However, contrary to OSD guidelines, it did not correctly identify any allowable sources of non-state funds that it used to pay for these expenses.

2. UNALLOWABLE PROFITS OF AT LEAST $18,623 SHOULD BE RETURNED TO THE COMMONWEALTH **10**

According to state regulations, for-profit contracted service providers such as KKI are required to negotiate the amount of commercial fees or profits they can make on their state contracts. However, we found that during the three-year audit period, KKI generated and retained profits totaling $51,292 in excess of its negotiated commercial fee, of which $18,623 was charged against KKI's state contracts.

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During our audit period, KKI owned two vehicles that were used primarily by its Executive Director and her husband and charged $21,966 in expenses associated with these vehicles against its state contracts. However, KKI did not have any formal written policies and procedures that provided for the provision of this fringe benefit to these individuals. According to state regulations, fringe benefits such as these that are not provided under an established policy of the agency are unallowable and non-reimbursable under state contracts. Additionally, we found that KKI did not require its Executive Director or her husband to document the business and personal use of these vehicles, and did not report the value of any personal use of these vehicles as a taxable fringe benefit on the Forms W-2 that it issued to its Executive Director or her husband.

4. UNDISCLOSED RELATED-PARTY TRANSACTIONS TOTALING AT LEAST $76,753 **16**

During our audit period, KKI hired both the son and son-in-law of the agency's Executive Director as sub-contractors to perform various computer and construction projects for the agency and paid them a total of $76,753. However, contrary to state regulations, KKI did not disclose these related-party transactions in the financial statements it filed with the Commonwealth.

5. INADEQUATELY DOCUMENTED ADMINISTRATIVE PAYROLL EXPENSES TOTALING AT LEAST $1,531,710 **20**

We found that contrary to OSD regulations and KKI's own policies and procedures, five members of the agency's administrative staff, KKI's Executive Director and four of her relatives, were not required to complete time records indicating the hours worked or the function benefited. As a result, there is inadequate assurance that the $1,531,710 in salaries and related payroll costs incurred by these five individuals during our audit period was reasonable.

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We found that KKI had not developed and implemented an adequate system of internal controls over many aspects of its operations. Moreover, in those areas where KKI had established some controls, we found that these controls, given the family nature of KKI's management structure, were often ineffective. 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 KKI's transactions were properly authorized, recorded, and reported.

INTRODUCTION

Background

Kiddie Kampus, Inc. (KKI), located in North Dartmouth, Massachusetts, was incorporated on August 25, 1989 as a private, non-sectarian, for-profit early childhood daycare center. The organization's mission is to provide quality care for children and their families. KKI strives to foster a safe, nurturing environment that promotes the physical, social, emotional, and cognitive development of young children with programs that are designed for three different stages of development: infant/toddler, pre-school, and school-age children. KKI is licensed by the state's Department of Early Education and Care (EEC) to provide childcare services for children ranging from infants to 14 years old at three locations within North Dartmouth. The agency has grown from originally serving 17 children at one location in 1989 to currently being licensed to serve 448 children ranging from infants to 14 years of age (131 infants and toddlers, 227 pre-schoolers, and 90 school-age children) at three locations.

During the audit period, KKI derived its revenues from various sources, including EEC's state contracts for Income Eligible, Supportive, and Teen Parent services, EEC's voucher-based funding, EEC's Community Partnerships for Children (CPC) funding, Department of Education (DOE) nutrition funding, and private sources, as follows:

Summary of Revenue

Revenue Sources	Fiscal year 2004	Fiscal Year 2005	Fiscal year 2006
EEC- Contract	$972,129	$1,109,147	$ 891,717
EEC- Voucher	906,517	998,266	1,495,145
CPC	49,760	122,625	138,260
DOE-Nutrition	198,600	209,489	254,592
Private Client Fees	650,724	771,940	892,768
Mass. Publicly sponsored client offsets[1]	105,388	115,347	191,349
Commercial Activities[2]	28,814	0	35,566
In-kind Contribution	0	0	50,932
Total	$2,911,932	$3,326,814	$3,950,329

[1] Families qualifying under EEC's Income Eligible contract are responsible for a portion of the childcare costs based upon their income level.

[2] Commercial Activities include Commercial Income, Book Sales, and Photo revenue, which have associated expenses.

Audit Scope, Objectives, and Methodology

The scope of our audit was to examine various administrative and operational activities of KKI during the period January 1, 2004 to December 31, 2006.

We conducted this audit in accordance with generally accepted government auditing standards for performance audits issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence that provides 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, in accordance with those standards.

Our audit procedures consisted of the following:

A determination of whether KKI had implemented effective internal controls, including:

- Processes for planning, organizing, directing, and controlling program operations.
- Policies and procedures to ensure that resource use is consistent with Massachusetts laws and regulations, and that resources are safeguarded and efficiently used.
- An assessment of KKI'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 KKI 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 KKI's accounting system. We used this assessment in planning and performing our audit tests. We then held discussions with KKI officials and reviewed organization charts; internal policies and procedures; and all applicable laws, rules, and regulations. We also examined KKI's financial statements, 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.

Our audit was not made for the purposes of forming an opinion on KKI's financial statements. We also did not assess the quality and appropriateness of all program services provided by KKI under

its state-funded contracts. Rather, our report was intended to report findings and conclusions on the extent of KKI's compliance with applicable laws, regulations, and contractual agreements, and to identify processes, methods, and internal controls that could be made more efficient and effective.

During the conduct of our audit work, we determined that KKI received a substantial amount of its funding (approximately 31% for fiscal year 2004, 30% for fiscal year 2005, and 38% in fiscal year 2006) through vouchers it received from its consumers that are funded by the federal Child Care and Development Fund provided by the United States Department of Health and Human Services. According to guidelines published by the U.S. Office of Management and Budget (OMB), any non-profit organization that receives these funds through voucher agreements is required to comply with the cost principles within OMB Circular A-122. However, since KKI is organized as a for-profit organization, the aforementioned OMB guidelines do not apply to the use of these funds. Rather, according to the OMB Circular A-133, the state agency that administers these funds, which in the case of Massachusetts is EEC, is required to establish controls over the use of these funds. In this regard, OMB Circular A-133 Section 210(e) states the following:

> *(e) For-profit subrecipient. Since this part does not apply to for-profit subrecipients, the pass through entity is responsible for establishing requirements, as necessary, to ensure compliance by for-profit subrecipients. The contract with the for-profit subrecipient should describe applicable compliance requirements and the for-profit subrecipient's compliance responsibility. Methods to ensure compliance for Federal awards made to for-profit subrecipients may include pre-award audits, monitoring during the contract, and post-award audits.*

Therefore, during our audit we met with EEC officials to discuss this matter, and on May 29, 2007, a member of EEC's legal counsel provided us with a letter on behalf of EEC, which stated, in part:

> *Voucher providers who are for-profit agencies and hold one or more contracts with EEC to provide subsidized child care are bound to the Commonwealth Terms and Conditions for Human and Social Services and 808 CMR 1.00 et. seq. These regulations and terms apply to all human and social service monies the provider receives, including voucher funds. If […] receives $100,000 or more in Commonwealth funds, it will have to file a Uniform Financial Report (UFR) and disclose voucher and contracted funds and follow the provisions of 808 CMR 1.00 (including those for non-reimbursable expenses and surplus revenue retention) and the audit preparation manual.*

However, during our audit we also met with federal officials, and on July 6, 2007, the Acting Regional Grants Officer of the U.S. Office of Grants Management Administration for Children and Families provided us with the following information he had received from the federal Child Care Bureau, as follows:

[Child Care and Development Fund] CCDF regulations give Lead Agency's specific responsibilities to ensure that CCDF is administered consistent with the regulations and State Plan. This includes ensuring that providers meet licensing requirements and afford parents access to their children. At 45 CFR 98.67, CCDF regulations also provide that "Lead Agencies shall expend and account for CCDF funds in accordance with their own laws and procedures for expending and accounting for their own funds." Thus, once a State receives its CCDF grant; State cost principles govern the funds rather than the Federal principles. States may audit child care providers to ensure that providers are in compliance with relevant State regulations.

We remind the State that in interpreting Federal and State regulations, CCDF funds provided through certificates or vouchers are considered assistance to the parent rather than a grant or contract to a provider (45 CFR 98.30(c)(6)). Additionally, Section 98.60(d)(6) provides that when CCDF funds are administered through vouchers or certificates, such funds will be considered obligated when a voucher or certificate is issued in writing to a family. Once the parent has submitted the voucher to a provider and received child care services, the funds have been both obligated and liquidated and have, thereby, lost their Federal character. As such, the funds are no longer subject to the statutory restrictions imposed by the Child Care and Development Block Grant Act, and may be used in any (lawful) manner that the provider chooses. Thus, when providers receive payment for child care services through a CCDF voucher or certificate from a parent, they are not subject to the requirements of OMB Circular A-133 or Federal limitations on the use of CCDF funds (e.g., restrictions pertaining to construction and renovation).

CCDF funds are designed to provide low-income families with access to the child care market comparable to privately paying families. The State should carefully consider the impact of any additional State fiscal requirements or regulations applied to financial operations of providers who accept certificates or vouchers as payment for serving CCDF subsidized children. Stringent fiscal requirements could disadvantage providers or represent additional costs related to the care of subsidized children, which could have the effect of restricting parental access and choice in the CCDF program. If the State wishes to adopt such policies we would suggest that they consider applying them to all providers, not just those serving subsidized families.

Given the positions of the federal funding agency and EEC relative to the applicability of state and federal regulations to these voucher funds, for the purposes of our audit, we recommend the recoupment of only state contract funds that we identified as being expended for non-reimbursable expenses after each audit result. However, we also identified any voucher funds that were expended which would be non-reimbursable if they are subject to Operational Services Division (OSD) regulations, so that if EEC believes, as it stated in its May 29th letter to us, that OSD regulations do in fact apply, then it can seek reimbursement of these additional funds.

AUDIT RESULTS

1. KKI DID NOT ACCURATELY REPORT TO THE COMMONWEALTH THE NON-STATE FUNDING IT USED TO PAY FOR AT LEAST $720,097 IN UNALLOWABLE COSTS

According to OSD guidelines, agencies that incur expenses that are non-reimbursable under their state contract are required to identify their expenses as well as the sources of non-state revenue used to pay for these expenses in the financial reports they file with the state's Operational Services Division (OSD), the agency responsible for regulating and overseeing the activities of contracted human service providers such as KKI. During fiscal years 2004 through 2006, KKI disclosed that it had incurred $720,097 in non-reimbursable expenses in the Uniform Financial Reports (UFRs) it filed with OSD. However, contrary to OSD guidelines, it did not correctly identify any allowable sources of non-state funds that it used to pay for these expenses.

OSD has established guidelines for the proper reporting of non-reimbursable costs by human services providers such as KKI. Specifically, OSD's Uniform Financial Statements and Independent Auditor's Report 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.*

In this regard, OSD has developed an attachment (Attachment 5) that is part of the UFRs that each contracted service provider must file annually. This attachment requires providers to identify, among other things, the program component where any non-reimbursable costs were incurred, the amount of non-reimbursable costs, and the source of allowable non-state funds that were used by the agency to pay for or offset these costs.

During fiscal years 2004 through 2006, KKI identified the following expenses as being non-reimbursable in the UFRs it filed with OSD:

Description	2004	2005	2006	Total
Employee Compensation	$ 18,098	$ 28,373	$ 7,367	$ 53,838
Occupancy	223,436	170,430	255,841	649,707
Admin Expenses (Auto)	0	0	2,966	2,966
Depreciation (Auto)	0	0	6,029	6,029
Other Expenses (Corporate Taxes & Contributions)	3,835	3,265	457	7,557
Total	$245,369	$202,068	$272,660	$720,097

During our audit, we determined that the expenses indicated in the table above were in fact non-reimbursable, and KKI appropriately disclosed these expenses as such in the UFRs it filed with the Commonwealth. We found that the revenues that KKI identified in its UFRs as being used to pay for these non-reimbursable expenses should not have been used for this purpose, according to OSD regulations. Specifically, the funding used to offset non-reimbursable expenses reported on KKI's UFRs during the audit period is as follows:

Revenue	2004	2005	2006	Total
DOE-Nutrition	$49,760	$122,625	$ 0	$172,385
CPC	198,600	209,489	0	408,089
Commercial Activities[3]	28,814	0	35,566	64,380
Private In-kind	0	0	50,932	50,932
Private Client Fees	0	0	892,768	892,768
Total	$277,174	$332,114	$979,266	$1,588,554

However, we noted that the majority of funding that KKI said it used to pay for these non-reimbursable expenses could not be used for these purposes according to OSD guidelines, as follows:

[3] KKI, in the 2006 UFR, reports Private Client Fees revenue as Commercial Activities. This revenue has been extracted from other revenue reported as Commercial Activities and reported as Private Client Fees.

- As noted above, KKI used Department of Education (DOE) Nutrition funds, Community Partnerships for Children (CPC) funds, and private client fees to pay for or offset the majority of the non-reimbursable costs it incurred during the period covered by our audit. However, OSD's UFR Audit & Preparation Manual gives the following guidance regarding what funds can be used to pay for or offset non-reimbursable expenses incurred by an agency:

> *Total unrestricted revenues available to defray non-reimbursable costs may only be derived from unrestricted and net assets released from restrictions that have been reported for the same program in which the non-reimbursable costs are reported…Certain revenues such as client resources or third party payments made on behalf of a client are commonly judged to be unrestricted revenues and available to defray non-reimbursable costs. However, when these revenues are received in a Commonwealth program, they must be used to defray or offset reimbursable operating costs and to reduce the amount of the Commonwealth's obligation for services rendered to the client. These revenues are commonly referred to as Commonwealth required offsetting revenues (defined in 808 CMR 1.02) to be used for program or invoice offsets.*

Since CPC funds are clearly restricted funds and the private client fees in question were received in a Commonwealth program and restricted to this program, these funds were not available to pay for KKI's non-reimbursable expenses in accordance with OSD's guidance. Further, OSD regulations specifically identify DOE Nutrition funds as being restricted and not available to offset non-reimbursable expenses. In this regard, 808 CMR 1.02 states, in part:

> *Any Contractor revenues and support (including but not limited to public and private grants, gifts, contributions, bequests, or any income there from, income from endowments, funds received from the Massachusetts Department of Education's Bureau of Nutrition, or similar funding) to the extent that revenues and support are restricted to use in the program…*

The Commercial Activity and Private In-Kind revenues that KKI reported as being available to offset its non-reimbursable expenses were in fact not totally available because there were expenses associated with these revenues, as indicated in the table below:

Year	Description	Revenue	Expense	Net Available for Offsets
2004	Commercial Activity	$28,814	$13,985	$14,829
2006	Commercial Activity	35,566	24,384	11,182
2006	Private In-Kind	50,932	50,932	0
Total				$26,011

As shown above, during fiscal years 2004 through 2006, KKI only had $26,011 in Commercial Activity and In-Kind funds to offset its non-reimbursable expenses, as opposed to what it

actually reported. However, as noted in the Background section of this report, KKI does receive federal funding. OSD's UFR Audit & Preparation Manual states that if an organization receives federal funds, funds derived from commercial activities cannot be used to offset non-reimbursable expenses, as follows.

> *UFR Audit & Preparation Manual pg.75-76: If the program is financed in whole or in part with federal assistance, the program income provisions of OMB Circular A-110 (Section 2 Definitions (x) and Section 24 (B)(3) and (d) permit a limited number and types of unrestricted revenues… For instance, income derived from the sale of commodities in a program that receives federal domestic assistance must be used to reduce the federal share of the program rather than to defray non-reimbursable costs.*

Therefore, none of the Commercial Activity or Private In-Kind revenues reported in KKI's fiscal years 2004 through 2006 UFRs would be considered eligible offsetting revenue that could be applied to the agency's non-reimbursable expenses.

Regarding this matter, KKI officials stated that they believe that the revenues the agency identified in the aforementioned UFRs as being available to pay for its non-reimbursable expenses could be used for these purposes.

Recommendation

In order to address our concerns relative to this matter, we recommend that KKI re-file its UFRs for fiscal years 2004 through 2006. As part of this process, KKI should correctly identify all the non-state offsetting revenue available to cover its non-reimbursable expenses. If KKI does not have sufficient non-state revenues to offset these expenses, then OSD should seek recoupment of the portion of state funds that was used to fund these non-reimbursable expenses, which we calculate to be $210,366, as indicated in the table below:

Year	Non-Reimbursable Expenses	Percentage of State Funding	Unallowable Non-Reimbursable Expenses
2004	$245,369	33%	$80,972
2005	202,068	33%	66,682
2006	272,660	23%	62,712
Total	$720,097		$210,366

In the future, KKI should take measures to ensure that it fully complies with all applicable regulations and accurately reports the non-state funding it uses to offset its non-reimbursable expenses.

Auditee's Response

In response to this issue, a law firm representing KKI provided comments which take issue with OSD's regulations that limit the amount of funding that can be paid by KKI to its related party for occupancy cost by stating, in part:

> *. . . KKI recognizes that the fundamental problem stems from the unfair treatment of its occupancy costs (i.e., rent) by the OSD regulations, over which the OSA has no direct control. The pertinent regulation, 808 CMR 1.05(8) allows only the lower of actual costs or fair market value ("FMV") when the cost item involves a related party transaction. KKI obtains administrative and program space from related parties under common ownership and control with KKI. While KKI fully disclosed its relatedness to Marjorie and Raymond Nunes, the owners of the properties, the application of 808 CMR 1.05(8) results in unfairness to KKI and a windfall to the Commonwealth for the following reasons:*
>
> - *First . . . [in the early 1990's] KKI responded affirmatively to the Commonwealth's request by acquiring property, building a facility compliant with all applicable childcare specifications, and putting it into service in 1996. In 1996, KKI was again invited to bid on childcare contracts, and the Commonwealth vigorously encouraged providers to increase their capacities. KKI was awarded this 1996 contract, and EEC still allowed rent charged by related parties at fair market value. Then in 1997, after KKI expanded, the related party regulation was changed to its current form.*
>
> - *Second, the buildings at issue were designed and built for dedicated childcare purposes. Had KKI obtained space from a non-related party, the rent, including appropriate build-out costs, would likely be greater than the rent charged by the related party.*
>
> - *Third, the treatment of the rent cost will lead to policy and program distortions. Subsidies to parents for children come in two forms: vouchers and contracted slots. Vouchers are federally funded and are subject to the federal view that the vouchers, once in the hands of the parents, are considered the parent's private money and are not subject to state reimbursement conditions. See Draft Report at pp. 3-4. Thus, the disallowance at issue applies only in the "Contract" program. The OSD regulation creates disincentives for providers to participate in the Contract program (which for various programmatic reasons is preferred by EEC) in favor of accepting voucher-supported children. In fact, absent regulatory relief, KKI is likely to drastically reduce its contracted slots.*
>
> - *Fourth, reimbursement in the Contract program is paid at a fixed, non-negotiated, take-it-or-leave-it rate by the state for all providers in each region. KKI provides excellent quality contracted slots for no more reimbursement than the state is willing to pay …*

Auditor's Reply

OSD regulations were promulgated to ensure the fair and equitable treatment of all of the Commonwealth's contracted human service providers, including KKI, and also to ensure that Commonwealth funds are adequately safeguarded against abuse and misuse. All contracted service providers are held to the same standards (OSD regulations and guidelines), which the Commonwealth, through OSD, has determined to be in the best interests of the taxpayers and citizens of the Commonwealth. During the OSA's audits of contracted service providers, any instances of non-compliance to these standards are reported regardless of whether or not an auditee believes these standards to be unfair. Consequently, in order to address our concerns relative to this matter, we urge KKI to fully implement our recommendations by re-filing its UFRs for fiscal years 2004-2006 and correctly identifying all the non-state offsetting revenue available to cover its non-reimbursable expenses.

2. UNALLOWABLE PROFITS OF AT LEAST $18,623 SHOULD BE RETURNED TO THE COMMONWEALTH

According to state regulations, for-profit contracted service providers such as KKI are required to negotiate the amount of commercial fees or profits they can make on their state contracts. However, we found that during the three-year audit period, KKI generated and retained profits totaling $51,292 in excess of its negotiated commercial fee, of which $18,623 was charged against KKI's state contracts.

The state's OSD has promulgated regulations relative to the amount of profit a for-profit organization such as KKI can earn under state contracts. In this regard, 808 Code of Massachusetts Regulations (CMR) 1.03(6), states, in part:

> *Commercial Fee: Departments are permitted to prospectively negotiate a for-profit earnings allowance for the purpose of furnishing a Commercial Fee to for-profit Contractors, which is in excess of the contract reimbursable operating costs for the services being procured. Departments are not required or expected to furnish a Commercial Fee, which is in excess of contract reimbursable operating costs to for-profit Contractors. Each contract executed between a department and a for-profit contractor must either a) explicitly indicate when a Commercial Fee has not been established by indicating that the earnings allowance is zero or b) clearly indicate the amount of negotiated earnings allowance, by percentage or dollar amount, in the contract. If a contract contains language that does not establish either an earnings allowance of zero or a specific negotiated earnings allowance, then the for-profit contractor may not retain a Commercial Fee from such a contract… The provisions of this language also apply to M.G.L. c.71B approved private special education Programs and contracts that utilize non-*

negotiated unit rates established by Departments… Department shall monitor the amount of Commercial Fee from the net surplus from Contract Revenues and reimbursable costs retained by each for-profit Contractor in any given year and recoup funds or reduce future prices when appropriate…

During our review of the contracts between KKI and EEC, which covered the period from fiscal year 2003 through fiscal year 2007 (through December 31, 2006), we noted that there was no language in any of these contracts that established a commercial fee. However, our review of KKI's financial records indicated that between fiscal years 2003 and 2006, KKI generated and retained a total of $1,528,529 in net profits including its commercial fee income, as indicated in the table below:

Operating Results

Year	Total Revenue	Total Expenses	Net Profits
2003	$2,932,308	$2,450,391	$481,917
2004	2,911,932	2,600,655	311,277
2005	3,326,814	3,018,831	307,983
2006	3,950,329	3,522,977	427,352
Total	$13,121,383	$11,592,854	$1,528,529

We brought the matter to the attention of KKI's Executive Director and she told us that EEC had in fact approved a commercial fee for KKI's state contracts. The Executive Director then provided us with a letter that KKI had received from EEC's Director of Contracting, dated August 26, 2004, that stated the following, in part:

. . . .The Office of Child Care Services (OCCS) has considered your request for a[n]. . . earnings factor for your OCCS funded child care programs. OCCS has reviewed your agency's financial statements to assess your agency's financial position. Based on this review, we have approved a[n]. . . earnings factor for your agency. . . .

This earnings factor will be applied to fiscal years 2003, 2004 and the current contract period of 2005.

Although we determined that EEC had in fact negotiated an earnings factor for KKI, during the three fiscal years 2004 through 2006, we found that KKI exceeded this negotiated earnings factor in its state-funded programs by $51,292.

Recommendation

In order to address our concerns relative to this matter, EEC should recover from KKI $18,623, which we calculate to be the percentage of state revenues relative to the unallowable commercial fees it retained during our audit period, as follows:

Year	Commercial Fees Above Approved Earnings Factor	Percentage of State* Funding	Unallowable Commercial Fees
2004	$29,085	40%	$11,634
2005	$7,639	40%	$3,056
2006	$14,568	27%	$3,933
Total	$51,292		$18,623

* These calculations have been adjusted to remove the funding and $78,303 in commercial fees generated by KKI in its school-age program that received no state contract funding.

In the future, KKI should take measures to ensure that it does not retain any profits in its state-funded programs in excess of those allowed by state regulations. Further, EEC should more closely monitor the UFRs it files with OSD and identify and recover any excessive commercial fees.

Auditee's Response

In response to this issue, a law firm representing KKI provided comments, which were fully considered in drafting our final report.

3. UNALLOWABLE VEHICLE COSTS TOTALING AT LEAST $73,219, OF WHICH $21,966 WAS CHARGED TO THE COMMONWEALTH

During our audit period, KKI owned two vehicles that were used primarily by its Executive Director and her husband and charged $21,966 in expenses associated with these vehicles against its state contracts. However, KKI did not have any formal written policies and procedures that provided for the provision of this fringe benefit to these individuals. According to state regulations, fringe benefits such as these that are not provided under an established policy of the agency are unallowable and non-reimbursable under state contracts. Additionally, we found that KKI did not require its Executive Director or her husband to document the business and personal use of these vehicles, and did not report the value of any personal use of these vehicles

as a taxable fringe benefit on the Forms W-2 that it issued to its Executive Director or her husband.

OSD has promulgated regulations that define certain costs that are unallowable and non-reimbursable under state contracts. In this regard, 808 Code of Massachusetts Regulations (CMR) 1.05(9) identifies the following expenses as non-reimbursable under state contracts:

> *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.*

Furthermore, Internal Revenue Service and Department of Revenue regulations require employers to furnish employees, the IRS, and DOR with accurate wage and earnings information amounts. Specifically, Section 713 of the U.S. Master Tax Guide states, in part:

> *All compensation for personal services, no matter what the form of payment, must be included in gross income. Wages, salaries, commissions, bonuses, fringe benefits, which do not qualify for statutory exclusions ….are income in the year received.*

Also, IRS Regulation 713, Fringe Benefits, which discusses the tax effect of personal use of company automobiles, states, in part:

> *The benefits may be included as income to the extent the employee uses them for personal purpose.*

During our audit period, KKI owned a 2004 Lexus LS430 and a 2004 Lexus LX470 that were provided to its Executive Director and her husband. The vehicles are KKI assets and are being depreciated by the agency. During fiscal years 2004 and 2005, KKI's Executive Director and her husband incurred expenses including depreciation, car insurance, repairs, and gasoline for these vehicles, as follows:

	2004	**2005**	**Total**
Depreciation	$26,032	$21,267	$47,299
Insurance	3,345	5,238	8,583
Excise Tax	856	1,790	2,646
Repairs, Maintenance, Gasoline	7,679	7,012	14,691
Total*	$37,912	$35,307	$73,219

* The agency incurred $31,610 in vehicle expenses during fiscal year 2006. However, when we brought this matter to the attention of KKI officials, the agency provided us with an analysis of the business versus personal use of the vehicles and also identified 30% of the expenses associated

with these vehicles as being non-reimbursable in its fiscal year 2006 UFR. KKI officials told us that this 30% is based upon the commuting mileage from the Executive Director's home to work as compared to the average total yearly mileage of these vehicles. KKI also created a written vehicle policy. Due to the agency's corrective action, we did not question 2006 vehicle expenses.

We reviewed the internal controls that KKI established over the use of these vehicles, as well as the documentation of expenses associated with these vehicles. Based on our review, we noted the following issues:

- During fiscal years 2004 and 2005, KKI did not have policies and procedures that required KKI's Executive Director or her husband to maintain a record of the business and personal use of these vehicles, and they also could not provide supporting documentation (e.g., travel logs or work schedules) regarding the business and personal use of these vehicles. Therefore, it was not possible to determine the extent to which this vehicle was used for business and non-business purposes. Also, the Executive Director's and husband's Forms W-2 for calendar years 2004 and 2005 did not include any amount for their personal use of these vehicles as required by IRS regulations.

- Neither KKI's policies and procedures during fiscal years 2004 and 2005 nor its employment contracts provided for the provision of this fringe benefit. Consequently, KKI's expenses associated with the provision of this fringe benefit are non-reimbursable in accordance with 808 CMR 1.05(9).

We brought this matter to the attention of KKI officials, and they provided us with a document, which they said was the agency's policy on automobile usage effective April 30, 2007, which stated, in part:

The company car (2004 Lexus LS430) and truck (2004 Lexus 470) are housed at the administrator's home as there are no secure garages at any of the Kiddie Kampus Locations.

During the day, the vehicles are used to purchase food and supplies, which are to be transported to the three different Kiddie Kampus locations.

In the event of child emergencies, the vehicles are used to accompany the child. Vehicles are used to shadow school buses on field trips in the event of an emergency on these field trips.

In addition, senior staff members may use the vehicles to attend child care meetings and conferences in the Boston area several times a month, as needed.

These vehicles are used to shuttle teaching staff from one location to another daily, as needed.

The owners of Kiddie Kampus, Inc. own their own personal vehicles.

Although this policy details that these vehicles are to be used for agency-related activities, KKI did not have any records to substantiate that these vehicles were used for these purposes.

Recommendation

In order to address our concerns relative to this matter, KKI should amend its fiscal years 2004 and 2005 UFRs to properly disclose the $73,219 in unallowable vehicle expenses we identified during our audit. As part of this process, KKI should correctly identify all the non-state offsetting revenue available to cover these non-reimbursable expenses. If KKI does not have sufficient non-state revenues to offset these expenses, then OSD should seek recoupment of the portion of state funds that were used to fund these non-reimbursable expenses, which we calculate to be $21,966, as indicated in the table below:

Year	Unallowable Vehicle Expense	Percentage of State Funding	Suggested Recoverable Vehicle Expenses
2004	$37,912	30%	$11,374
2005	35,307	30%	10,592
Total	$73,219		$21,966

In the future, KKI should not charge any expenses associated with unallowable fringe benefits such as these against its state contracts.

Auditee's Response

In response to this issue, a law firm representing KKI provided comments, which are excerpted below:

> *...KKI disputes the Draft Report's treatment of these issues, including the following errors:*
>
> - *As a potential resolution, KKI believes that OSA would accept a minimum 70% business use estimate for purposes of the audit. If so, the disallowance for FY 2004 and 2005 should be 33% of 30%, not of the entire amount. . .*
>
> *As the Draft Report comments . . . on the income tax treatment of fringe benefits in IRS Regulation 713, it is important to note that KKI vigorously disputes any personal use of the vehicles in question. The Executive Director and her husband have their own personal vehicle for personal use. . .*
>
> *The KKI vehicles identified in the Draft Report are used for business purposes, including the purchase and distribution of food and supplies to the multiple KKI sites, emergency transportation of children, field trips, transporting teachers among the multiple sites as needed, and use by staff to attend business-related meetings. The vehicles are garaged at the [name of KKI's Executive Director] residence because the KKI school buildings are*

located near UMass-Dartmouth fraternity houses where they are subject to the foreseeable hazards of proximity to the unruly residents of such facilities. Moreover, as the property is situated over an aquifer, the Town of Dartmouth will not permit KKI to construct garages on site to protect the vehicles.

Nonetheless, as noted in the Draft Report, KKI has accepted the OSA's recommendations and implemented them for FY2006. The Report does not question the 2006 vehicle expense items. Accordingly, other than to note for the record that it disputes the Draft Report's presumption that the vehicles were used for personal, non-KKI purposes, KKI offers no further comment on this item.

Auditor's Reply

As noted in our report, neither KKI's Executive Director nor her husband kept a record of the business versus the personal use of these vehicles during fiscal years 2004 and 2005. Consequently, it would not be prudent or appropriate for us to accept the business versus personal use percentage KKI suggests in its response. Clearly, both IRS regulations and state contract conditions require that agencies such as KKI maintain adequate documentation for all business expenses, including vehicle expenses. However, as stated in our report, KKI did not meet these documentation requirements during these two fiscal years.

In its response, KKI stated that "it vigorously disputes any personal use of the vehicles in question." However, this assertion is contrary to the agency's own records that it provided to us during our audit in which the two individuals in question clearly recorded personal use of these vehicles during fiscal year 2006. Since these vehicles are garaged at the home of KKI's Executive Director, and both she and her husband used these vehicles for commuting during fiscal years 2004 and 2005, and commuting mileage is personal use, it is reasonable for us to assume that there was at least this level of personal use of these vehicles during the period.

4. UNDISCLOSED RELATED-PARTY TRANSACTIONS TOTALING AT LEAST $76,753

During our audit period, KKI hired both the son and son-in-law of the agency's Executive Director as sub-contractors to perform various computer and construction projects for the agency, and paid them a total of $76,753. However, contrary to state regulations, KKI did not disclose these related-party transactions in the financial statements it filed with the Commonwealth.

OSD has promulgated regulations relative to related-party transactions. In this regard, OSD defines a related-party as follows in 808 CMR 1.02:

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 states, in part:

Examples of related party transactions include transactions between (a) a parent company and its subsidiaries; (b) subsidiaries of a common parent. . . .Transactions between related parties commonly occur in the normal course of business. Some examples of common types of transactions with related parties are: sales, purchases, and transfers of realty and personal property, services received or furnished, for example, accounting, management, engineering, and legal services; use of property and equipment by lease or otherwise; borrowing and lendings, guarantees; maintenance of bank balances as compensating balances for the benefit of another; inter-company billings based on allocations of common costs; and filings of consolidated tax returns. Transactions between related parties are considered to be related party transactions even though they may not be given accounting recognition. For example, an enterprise may recover services from a related party without charge and not record receipt of the services.

OSD has also published various documents that provide guidance to human services organizations such as KKI 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 UFR Auditor's Compliance Supplement under 808 CMR 1.00, published by OSD and in effect during the audit period, states, in 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. . . .

Finally, OSD has established penalties for organizations that do not comply with its regulations regarding the disclosure of related-party transactions; 808 CMR 1.04 (11)(c) 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 than $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) or 1.05, DPS may debar the contractor for a period not to exceed five years.

During our audit, we determined that KKI conducted business with two related-party organizations and paid these related parties a total of $76,753. However, the agency failed to

disclose these related-party transactions in the UFRs that it filed with OSD as required by OSD regulations. The specific undisclosed related-party transactions are identified as follows:

a. Undisclosed Related-Party Transactions for Technology Services Totaling $16,723

During our audit, we noted that KKI was incurring computer-related expenses from a company named CompuBuy Computers (CompuBuy). KKI's Executive Director told us that the agency's full-time Information Technology (IT) Director, who is also her son, owned CompuBuy. As such, KKI's transactions with CompuBuy constitute related-party transactions and are subject to the applicable OSD regulations. However, we reviewed the UFRs filed by KKI during the audit period and found that, contrary to OSD regulations, CompuBuy expenses were not disclosed as related-party transactions.

b. Undisclosed Related-Party Transactions Totaling $60,030 with Executive Director's Son-In-Law

During our audit period, KKI hired J. Melo Maintenance to perform various maintenance, cleaning, and landscaping tasks at KKI's three program sites in North Dartmouth. In return for these services, this contractor was paid at a rate of $450 per week. The expenses paid by KKI to this sub-contractor totaled $60,030 during the audit period. KKI officials told us that this sub-contractor was married to the agency's Account Director, who is KKI's Executive Director's daughter. Consequently, the transactions between this contractor and KKI represent related-party transactions, which should have been disclosed on the agency's UFRs.

However, our review of KKI's fiscal years 2004 and 2005 UFRs indicated that the agency did not report these related-party transactions in the UFRs it filed with the Commonwealth during fiscal years 2004 and 2005.

Because the related-party transactions detailed in (a) and (b) above were not disclosed in KKI's UFRs, the agency failed to provide the Commonwealth and other users of this information with the information necessary to properly monitor and evaluate KKI's fiscal, operational, and programmatic activities during the audit period.

We brought this matter to the attention of KKI officials and they stated that they were unaware that these transactions needed to be disclosed as related-party transactions in their financial statements. However, subsequent to bringing this matter to their attention, KKI did disclose

these related-party transactions in the notes to the financial statements in its fiscal year 2006 UFR.

Recommendation

To address our concerns regarding this matter, KKI should take measures to ensure that all related-party transactions are disclosed in accordance with OSD regulations.

Auditee's Response

In response to this issue, a law firm representing KKI provided comments, which are excerpted below:

> *KKI is a family-owned and operated business. Its employees naturally include family members. KKI also hired a company (CompuBuy) owned by the Executive Director's son to perform various computer projects and a company (J.Melo Maintenance) owned by her son-in-law to perform various maintenance and landscaping projects. Together, both businesses were paid a total of $76,753. The Draft Report finds that these transactions were not properly reported as related-party transactions, but does not question the fairness of the amounts charged for the services rendered.*
>
> *KKI has always followed its CPA's guidance in disclosing necessary information in its UFRs. It was therefore not aware that these transactions needed to be reported as related party transactions. Further, it is not apparent that the regulatory definition of "related party" in 808 CMR 1.02 (which simply refers to and incorporates FASB 57), covers the relationships at issue (KKI's owners and control group do not own or control the companies at issue), but KKI defers to the Draft Report's determination that the transactions at issue qualify as those of related parties.*
>
> *In any case, KKI has no objection in principle to the disclosure of such transactions and accepts the OSA recommendation to report these kinds of transactions. KKI has done so in its FY 2006 UFR and thereafter.*

Auditor's Reply

We acknowledge the fact that KKI is a family-owned business. However, because KKI has chosen to accept state contract funds, it is responsible for being cognizant of and complying with all state regulations, including those relative to related-party transactions. Consequently, we again recommend that KKI take necessary measures to ensure that all of its related-party transactions are disclosed in accordance with OSD regulations.

5. INADEQUATELY DOCUMENTED ADMINISTRATIVE PAYROLL EXPENSES TOTALING AT LEAST $1,531,710

We found that contrary to OSD regulations and KKI's own policies and procedures, five members of the agency's administrative staff, KKI's Executive Director and four of her relatives, were not required to complete time records indicating the hours worked or the function benefited. As a result, there is inadequate assurance that the $1,531,710 in salaries and related payroll costs incurred by these five individuals during our audit period was reasonable.

OSD has promulgated the General Audit and Compliance Requirements with which all human services providers that contract with state agencies must comply. According to these requirements, contracted human services providers such as KKI are required to maintain accurate and complete financial records, including payroll records, in order to receive reimbursement of these costs. Specifically, OSD's General Audit and Compliance Requirements state, in part:

> *Personnel records must be sufficient to meet all state and federal employment, wage and labor standards, GAAP internal control needs and industry reporting requirements. The personnel and payroll records maintained by the contractor and subcontractor must also adequately and clearly document all staff time directly charged or allocated to state or federally funded contracts.*

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)…*

During our audit, we determined that KKI's Executive Director, Treasurer, Chief Financial Officer, Curriculum Director, and IT Director did not complete time records reflecting the hours they worked or function benefited during our audit period. Furthermore, these employees' vacation and sick time was not being properly accrued or recorded in the agency's accounting records. This is contrary to OSD regulations and KKI's unwritten policy of requiring all other

employees to fill out time and attendance records and to accrue paid leave as it is earned, in accordance with the following written agency policy:

> *. . . After being employed by Kiddie Kampus, Incorporated for a period of one year all employees are entitled to (1) one paid week vacation, after (2) two years of employment, an employee is entitled to (2) two weeks paid vacation, and, after (5) five years of employment, an employee is entitled to (3) three weeks paid vacation." There has been an updated edition to the Vacation Policy effective September 1, 2005. " If you have one week paid vacation time, you may request your week for anytime between September 15th and August 31. If you have two weeks vacation time, you may take those two weeks anytime except between July 1st and August 31st; you may take only one of your weeks during this time period. If you have three weeks vacation time, you may: a. Take three weeks anytime between September 15th and May 20th. (These weeks may be taken consecutively.) OR b. Take one week between July 1st and August 31st, and the remaining two weeks any time you would like between September 15th and June 30th." Point number 9 of the updated Vacation Policy states " No more than two people at each location may take vacation at the same time, except for the week of July 4th.*

During the audit period, these five related individuals received compensation totaling $1,531,710.

Regarding this matter, KKI's Executive Director stated that she was not aware that the agency needed to maintain time records for these employees, but added that KKI is a family-run corporation and, as such, these five employees are required to provide a wide scope of services in order for the corporation to be successful. The Executive Director added that because each of these employees performs numerous tasks, tracking these individuals' time as to function benefited would be difficult.

Subsequent to our bringing this matter to the attention of agency officials, KKI's Executive Director told us that, effective immediately, all of the five employees in question would complete time records. Based on the Executive Director's assertion, we conducted additional audit testing to assess the reasonableness of the actions taken by KKI in this matter. We found that the KKI administrative employees in question are currently filling out attendance records and maintaining records of accrued paid leave balances. However, these time records do not track the amount of time each employee spends on each function.

Recommendation

KKI should take further measures to ensure that its payroll records are maintained in accordance with OSD regulations.

Auditee's Response

In response to this issue, a law firm representing KKI provided comments, which are excerpted below:

> *OSD requires that providers comply with record-keeping practices, including time, sick leave and vacation records. All KKI administrative staff (family and non-family alike) customarily called their information in to be recorded by KKI's payroll clerk. Accordingly, KKI did not maintain full written records for its administrative staff to the satisfaction of the OSA, which requires sign-in, sign-out sheets.*
>
> *KKI accepts the OSA recommendation and currently maintains the requisite records. . . .*

Auditor's Reply

We believe the actions taken by KKI in this area were necessary and again recommend that KKI take measures to ensure that its payroll records are maintained in accordance with OSD regulations.

6. INADEQUATE INTERNAL CONTROLS OVER AGENCY OPERATIONS

We found that KKI had not developed and implemented an adequate system of internal controls over many aspects of its operations. Moreover, in those areas where KKI had established some controls, we found that these controls, given the family nature of KKI's management structure, were often ineffective. 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 KKI's transactions were properly authorized, recorded, and reported.

According to generally accepted accounting principles (GAAP), entities such as KKI 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 are maintained, reported, and fairly disclosed in reports.

In order to comply with GAAP, KKI should have a documented comprehensive plan of internal controls 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, as well as 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 internal control problems discussed in the other Audit Results detailed in this report, KKI had not established adequate internal controls over other aspects of its operation. The following is a summary of the additional internal control issues we identified during our audit.

- Failure to Adequately Document the Internal Control Environment and the Accounting System: Sound business practices advocate that entities such as KKI 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 that are utilized in KKI'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 operational activities. However, during our review we noted that KKI had not established formal written accounting procedures or an accounting manual.

- Weakness in the Overall Control Environment: OSD's UFR Auditor's Compliance Supplement states, in part: "*The contractor is also required to maintain adequate written policies and procedures for accounting and management and personnel activities in accordance with GAAP, including but not limited to conflict of interest and nepotism policies.*" Despite this requirement, we found that KKI did not have policies or procedures to address all of these areas. Moreover, the way in which KKI management is currently organized results in family members directly supervising other family members, which is not consistent with sound internal control practices. Consequently, the overall control environment within KKI is such that any control measures implemented may be ineffective due to the management structure. Specifically, KKI's Executive Director's husband, two of her children, and two of her children's spouses were employed in management positions, and other children and grandchildren had direct care positions or indirect involvement within KKI.

Recommendation

In order to address our concerns relative to this matter, we recommend that KKI immediately develop and implement adequate internal controls over all aspects of its operations consistent with the guidance provided in OSD's UFR Auditor's Compliance Supplement.

Auditee's Response

In response to this issue, a law firm representing KKI provided comments, which are excerpted below:

> *The Draft Report does not identify duly promulgated regulations violated by KKI, but instead relies on GAAP and OSD guidance publications. Particularly in light of what it calls KKI's "nepotistic" management structure, the Draft Report finds (a) a failure to adequately document the internal control environment and counting system and (b) weakness in the overall control environment due to nepotism and the potential for conflict of interest problems.*
>
> *It is unclear what would be required to implement the OSA recommendations and whether they would alter the fundamental nature of KKI as a "family" business. . . In connection with this item, KKI has recently hired a new administrative staff person with substantial experience (18 years at Brown University). One of her assignments will be to revise and upgrade KKI's policy and procedure manual. Any resources or other technical assistance from the OSA will be appreciated.*
>
> *As indicated above, however, KKI is fundamentally a family business and it values the "family" nature of its management structure. It hopes to achieve the objectives of Item 6 by implementing measures that will not materially impair the "family" nature of the way it has chosen to operate.*

Auditor's Reply

As stated in our report, we found that the agency's internal controls over its accounting activities need to be improved, and that the organization of KKI's management structure is not consistent with sound internal control practices. While we recognize that KKI is a family-operated business, it still has a responsibility to ensure that adequate internal controls exist to ensure that agency transactions are properly authorized, recorded, and reported, and that the organization's assets, which are partly derived from state funding, are properly safeguarded against abuse and/or misuse. There are many ways an organization, even one that is family-owned and operated like KKI, can seek to accomplish this task. Some measures would include obtaining outside independent directors to serve on the agency's board, taking measures to ensure that family members are not supervised and/or evaluated by other family members, and adopting formal conflict-of-interest and anti-nepotism policies and procedures. However, we strongly suggest that KKI utilize the services of its private accountant to determine how to best implement proper controls over its organization.