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INDEPENDENT STATE AUDITOR'S REPORT ON CERTAIN ACTIVITIES OF LITTLE PEOPLE'S COLLEGE, INCORPORATED JULY 1, 2004 TO DECEMBER 31, 2006

OFFICIAL AUDIT REPORT

AUGUST 19, 2008

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Little People's College, Incorporated (LPC) was incorporated in 1980 as a for-profit human service organization. LPC provides early care and education for children ages one month through 12 years, primarily to families residing in communities in southeastern Massachusetts. LPC is licensed by the Massachusetts Department of Early Education and Care (EEC) and is accredited by the National Academy of Early Childhood Programs.

The scope of our audit was to examine various administrative and operational activities of LPC during the period July 1, 2004 to December 31, 2006. Our audit procedures consisted of the following:

A determination of whether LPC 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 LPC'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 the period covered by our review, LPC incurred $123,924 in expenses that were nonreimbursable to its state contracts and expensed $27,263 of this amount against these contracts, did not have adequate documentation to support all of its payroll expenses, received excessive reimbursements under it state contracts totaling $21,005, and had not developed and implemented an adequate system of internal controls over certain aspects of its operations. Moreover, we found that the composition of LPC's Board of Directors and management structure did not adequately provide independent oversight of LPC's operations.

During our audit period, LPC incurred a total of $278,766 in credit card expenses. We reviewed the documentation LPC was maintaining relative to $105,875 of these expenses and found problems with $19,063 of them in that they were either inadequately documented or did not appear to be related to the operation of LPC's state-funded programs. For example, $14,044 was expended for various pieces of gold and diamond jewelry and a Rolex watch. According to state regulations, expenses such as these that are inadequately documented or not directly related to the program activities of service providers are nonreimbursable under state contracts. LPC charged $4,194 of these nonreimbursable expenses against its state contracts.

We found that, contrary to state regulations and the terms and conditions of its state contracts, LPC had not established adequate controls over the documentation and allocation of compensatory expenses for its administrative staff. Specifically, LPC did not require administrative staff members to document the hours worked or the functions benefited (e.g., specific program, cost center, contract) and did not follow its own policies and procedures relative to documenting the hours worked by its non-salaried employees in state programs. As a result, there is inadequate assurance that all of the compensatory expenses incurred by LPC's employees during our audit period were granted in accordance with Massachusetts regulations and the terms and conditions of LPC's state contracts.

We found that LPC had not established adequate controls relative to the administration of its seven petty cash funds, from which LPC expended $124,327 during our audit period. We reviewed the documentation LPC was maintaining relative to $45,118 of these expenses and found that $43,227 of these expenses were undocumented, inadequately documented, or not related to the activities of LPC's state-funded programs. LPC charged $9,510 of these expenses against its state contracts.

We found that LPC requested and received reimbursements from EEC that exceeded the maximum obligation of its state contracts by a total of $21,005 for fiscal years 2005 and 2006. According to LPC officials, when EEC and LPC became aware of these overbillings, EEC notified LPC that it could keep these funds and record these revenues as "flexible pool" funding, which EEC provides to human service providers to assist families that have continuity-of-care needs or special transportation/service needs that current contract capacity cannot accommodate. However, LPC did not record this revenue as flexible pool revenue but as contract revenue. As a result, LPC overbilled these contracts by $21,005.

During our audit period, LPC provided vehicles owned by LPC to its Chief Executive Officer (CEO) and Chief Financial Officer (CFO) for their personal use and incurred an estimated $61,634 in expenses associated with these vehicles, of which $13,559 was charged against LPC's state contracts. However, LPC 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 nonreimbursable under state contracts. Additionally, we found that LPC did not require these two individuals to document the business and personal use of the vehicles and did not report the value of any personal use of the vehicles as a taxable fringe benefit on the Forms W-2 that it issued to its CEO and CFO.

6. CORPORATE MANAGEMENT STRUCTURE OF LPC DOES NOT PROVIDE ADEQUATE CONTROLS OVER AGENCY OPERATIONS **17**

We found that LPC's overall organizational structure does not provide adequate controls over LPC operations. Specifically, during our audit period LPC's Board of Directors was composed of five individuals, four of whom were related to the agency's CEO. Moreover, three of the four related individuals also held agency positions within LPC. Further, eight of the CEO's family members were employed by LPC during our audit period, and six of these eight individuals were under the direct supervision of another family member. As a result of these internal control weaknesses, we question whether LPC's board is able to perform all of its responsibilities in an effective, efficient, and independent manner.

7. INADEQUATE INTERNAL CONTROLS OVER CERTAIN AGENCY OPERATIONS **20**

We found that LPC had not developed and implemented an adequate system of internal controls over certain aspects of its operations. Specifically, we found that LPC did not establish an acceptable cost allocation plan to allocate its indirect costs as required by Operational Services Division (OSD) regulations and did not establish an effective inventory system for its fixed assets. As a result, LPC cannot ensure that all of its indirect costs were properly allocated to its programs or that its inventory of fixed assets is properly safeguarded against loss, theft, or misuse. The following is a summary of the additional internal control issues we identified during our audit:

a. LPC Did Not Properly Establish Methods to Pool and Allocate Indirect and Direct Program Costs **20**

During our audit, we reviewed the accounts that LPC planned to allocate to its program and noted that LPC's accounts did not contain a number of general indirect agency expenses (e.g., telephone services, utilities, office supplies, postage, delivery, mileage for administrative staff). In fact, the CEO's salary and benefits composed the majority of expenses allocated by LPC's Board of Directors during our audit period, whereas legal, accounting, and nominal items received the remainder of funding. Other administrative expenses were charged to LPC's programs, despite the fact that they were not direct costs to these programs.

b. LPC Did Not Maintain an Accurate Inventory System **21**

During our audit we found that LPC did not have a listing of its fixed assets (capital items) in accordance with state regulations. Further, LPC does not routinely conduct a physical inventory of its fixed assets. The lack of a written inventory listing by type, location, amount, and acquisition valuation for its entire inventory puts LPC and the Commonwealth at financial risk for the replacement cost of these untagged and undocumented items.

INTRODUCTION

Background

Little People's College, Incorporated (LPC) was incorporated in 1980 as a for-profit human service organization. LPC provides early care and education for children ages one month through 12 years, primarily to families residing in communities in southeastern Massachusetts. The Massachusetts Department of Early Education and Care (EEC) licenses LPC's center-based operations, and LPC is accredited by the National Academy of Early Childhood Programs.

During our audit period, LPC received its funding from various sources, including three contracts with EEC: an Income Eligible Contract, a Supportive Services Contract, and a Teen Parent Contract. The table below identifies the funding received by LPC during the period covered by our audit.

Fiscal Years* 2004 through 2006

Source	FY 2006	FY 2005	FY 2004
EEC Contracts	$905,168	$843,862	$798,265
EEC Voucher	1,587,618	1,490,186	1,838,381
Mass. Govt./ Other Grant	223,149	212,439	239,172
Local/Quasi Govt.	190,179	176,305	135,032
Client Offsets	289,860	240,053	256,936
Private Pay Clients	569,997	592,282	556,806
Investments and Other	117,877	91,495	97,847
Total	$3,883,848	$3,646,622	$3,922,439

* LPC's fiscal year runs from January 1st through December 31st

Audit Scope, Objectives, and Methodology

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

We conducted this performance audit in accordance with generally accepted government auditing standards. 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.

Our audit procedures consisted of the following:

A determination of whether LPC 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's laws and regulations and that resources are safeguarded and efficiently used.
- An assessment of LPC'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 LPC 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 LPC's accounting system. We used this assessment in planning and performing our audit tests. We then held discussions with LPC officials and reviewed organization charts; internal policies and procedures; and all applicable laws, rules, and regulations. We also examined LPC'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 LPC's financial statements. We also did not assess the quality and appropriateness of all program services provided by LPC under its state-funded contracts. Rather, our report was intended to disclose findings and conclusions on the extent of LPC's compliance with applicable laws, regulations, and contractual agreements, and to identify services, processes, methods, and internal controls that could be made more efficient and effective.

AUDIT RESULTS

1. UNALLOWABLE AND NONREIMBURSABLE CREDIT CARD EXPENSES TOTALING AT LEAST $4,194

During our audit period, Little People's College, Incorporated (LPC) incurred a total of $278,766 in credit card expenses. We reviewed the documentation LPC was maintaining relative to $105,875 of these expenses and found problems with $19,063 of them in that they were either inadequately documented or did not appear to be related to the operation of LPC's state-funded programs. For example, $14,044 was expended for various pieces of gold and diamond jewelry and a Rolex watch. According to state regulations, expenses such as these that are inadequately documented or not directly related to the program activities of service providers are nonreimbursable under state contracts. LPC charged $4,194 of these nonreimbursable expenses against its state contracts.

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

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

During fiscal years 2005 and 2006, LPC allowed several members of its administrative staff to use their personal credit cards to pay for $278,766 in expenses and subsequently reimbursed these individuals for these expenses. During our audit, we first assessed the internal controls LPC had established relative to credit card expenses. In this regard, LPC's Credit Card Policies and Procedures state the following:

> *The Chief Executive Officer and/or the Chief of Fiscal Operations are designated to be responsible for the oversight of credit card use.*
>
> *Only those who are authorized may use a credit card. Authorization is granted by the Chief Executive Officer or the Chief of Fiscal Operations. Those authorized should only purchase goods or services for the business of Little People's College.*

If the employee is not an authorized purchaser, there should be a form of documentation, such as a purchase order or itemized listing, with an authorized purchaser's approval and the name of the individual making the purchase.

Invoices shall be reviewed and approved prior to payment.

Although LPC has established the aforementioned policies and procedures regarding credit card expenses, we determined that there were inadequate controls over credit card usage and the repayment of these expenses to agency staff. Specifically, we found that there were no written procedures that require individuals who use their personal credit cards to pay for agency expenses to document the date, place, amount, and nature of each expense, or to submit original receipts to substantiate the reasonableness and appropriateness of these expenditures. Further, despite LPC's policy that invoices shall be reviewed and approved prior to payment, we saw no evidence of LPC's administrative staff performing independent reviews of these expenses to determine their reasonableness and allowability.

Based on these internal control problems, during our audit we reviewed the documentation LPC was maintaining relative to $105,875 of these credit card expenses it incurred during fiscal years 2005 and 2006 and identified some problems with these expenses. Specifically, $19,063 of these expenses appeared to be non-program-related or lacked adequate supporting documentation. In terms of the inadequately documented expenses, some had no receipts whereas others were justified by credit card statements that did not indicate the business nature of the expense.

Included in the non-program-related expenses were the following items:

- A January 18, 2005 expense of $1,750 for a jewelry purchase at Landmark Jewelers in the Cayman Islands.
- An August 6, 2005 expense of $3,000 for gift certificates at Silver City Galleria.
- A December 13, 2005 expense of $1,982 for a "Spa Night" at Gloria and Company.
- A November 24, 2006 expense of $2,125 for a diamond bracelet.
- A December 2, 2006 expense of $4,095 for a diamond Rolex watch.
- A December 2, 2006 expense of $2,782 for a diamond bracelet.
- A December 17, 2006 expense of $3,292 for a gold chain and diamond bracelet.

Furthermore, LPC did not declare these expenses as nonreimbursable in the Uniform Financial Statements and Independent Auditor's Reports (UFRs) it filed with OSD, the agency responsible for overseeing the activities of contracted human service providers such as LPC.

Regarding these matters, LPC's CFO indicated that that she was not able to locate all the documentation relative to the expenses in question.

Recommendation

In order to address our concerns relative to this matter, LPC should amend its fiscal year 2005 and 2006 UFRs to identify the state funds that were used to pay for these non-program-related expenses as nonreimbursable, which we calculate to be $4,194 ($19,063 in questionable expenses multiplied by 22%, the average amount of state funding provided during the audit period). Additionally, LPC should develop and implement more comprehensive controls over its credit card expenses. For example, all credit card invoices should be attached to credit card statements, and the statements should be marked as paid with the date of payment, the check number of the payment, the amount of the payment, and the account charged for the payment. Expenses submitted for reimbursement should be clearly documented relative to the date, place, amount, and nature of each expense. Personal credit card invoices should be clearly marked and clearly distinguished as personal upon payment by the credit card holder. There should be no reimbursements by LPC for items appearing on credit card statements without the tracking invoices or verification of delivery of services from the transaction.

Auditee's Response

In response to this audit result, LPC officials stated, in part:

> *We do conduct independent reviews of expenses. This is evidenced by the reviewer's initials found on the receipts, the spreadsheets or the invoices themselves. In addition, one of the reviewers often identifies the accounts to which the credit card transactions apply. . . .*
>
> *The jewelry items that are listed were bought for our appreciation raffles or as appreciation gifts for staff members in accordance with our policy. The value of the items is irrelevant. The Spa Night includes all 10+ year staff members who are part of the LPC team and the gift certificates are awarded at an appreciation event that we hold in August each [year] . . . .*
>
> *In fact, we do have credit card invoices filed in places other than with the statement, when we need the receipts for warranties or reimbursements. We did offer to sort*

through all areas to locate additional documentation but we understood it to be unnecessary.

Auditor's Reply

As stated in our report, during our audit we found that LPC had not established adequate controls over its credit card expenses. In its response, LPC contends that all credit card expenses are subject to an "independent review." However, we were not provided with any documentation to substantiate this assertion.

In its response, LPC contends that the items that we identified as being non-program-related were in fact business expenses in that the items in question were provided to LPC staff. However, we were not provided with any documentation to substantiate this assertion. Further, we were not provided with any agency policy indicating that staff members were eligible to receive the jewelry items that we identified in our sample

Finally, the audit team requested all documentation relative to the expenses being reviewed. If other documentation existed, it clearly should have been provided to the audit team during the conduct of its audit fieldwork. Consequently, our conclusions were based on the documents that were provided and our conversations with responsible agency officials.

2. INADEQUATELY DOCUMENTED PAYROLL EXPENSES

We found that, contrary to state regulations and the terms and conditions of its state contracts, LPC had not established adequate controls over the documentation and allocation of compensatory expenses for its administrative staff. Specifically, LPC did not require administrative staff members to document the hours worked or the functions benefited (e.g., specific program, cost center, contract). As a result, there is inadequate assurance that all of the compensatory expenses incurred by LPC's administrative employees during our audit period were granted in accordance with Massachusetts regulations and the terms and conditions of LPC's state contracts.

According to the terms and conditions of its state contracts, LPC is required to maintain accurate and complete financial records, including payroll records, in order to receive reimbursement for its costs. Specifically, the contract between LPC and the Commonwealth states, in part:

> *The provider will maintain personnel records for each employee. These records shall include but not be limited to…payroll records, and…attendance records or effort reports, documenting program and assignment and hours and days worked.*

Furthermore, 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. . . .*

In addition, Chapter 151, Section 15, of the Massachusetts Laws describes the expectation of employers concerning payroll and timekeeping documentation as follows:

> *Every employer shall keep a true and accurate record of the name, address and occupation of each employee, of the amount paid each pay period to each employee, of the hours worked each day and each week by each employee, and such other information as the commissioner or the attorney general in their discretion shall deem material and necessary. Such records shall be kept on file for at least two years after the entry date of the record. Such records shall be maintained at the place of employment, at an office of the employer, or with a bank, accountant or other central location and shall be open to the inspection of the commissioner or the attorney general, or their authorized representatives at any reasonable time, and the employer shall furnish immediately to the attorney general, commissioner or representative, upon request, a copy of any of these records. . . .*

During our audit, we asked LPC to provide us with the agency's policies and procedures relative to the documentation of the time and attendance for its staff. In response, LPC officials provided us with a copy of LPC's policy, which appears in its accounting manual, as follows:

> *2. Time sheets*
>
> *Sheets come in from each school; hours are calculated for each day for each employee*
>
> *If week has a holiday, 6 hrs must be worked day before and 6 hrs after the holiday for eligible employee to be paid holiday pay*
>
> *Any meetings, team trainings, added to "extra time" column, for employees that attended*
>
> *Once all time is calculated, columns are added down for the weekday and across for the employee and totaled, totals must match to prove, if not check for discrepancies*

Although this policy clearly requires LPC's staff to submit time sheets, there were no special timesheet procedures indicated in this manual for senior executives or administrators. Given this internal control problem, we reviewed the time and attendance information LPC was maintaining for three of its administrative staff members (its CEO, CFO, and its Chief of Maintenance) for fiscal years 2005 and 2006. Based on our review of this information, we determined that none of these three individuals submitted timesheets. Rather, LPC's CFO and CEO prepare a statement of work or an employee log of their time that identifies the hours worked on particular tasks, but this record is incomplete and is not submitted as a payroll time and attendance record. The Chief of Maintenance, on the other hand, does not submit any record of time for weekly payroll processing. As a result, there is inadequate assurance that all of the compensatory expenses incurred by LPC's administrative employees during our audit period were granted in accordance with Massachusetts regulations and the terms and conditions of LPC's state contracts.

Recommendation

LPC should develop and implement written policies and procedures regarding the maintenance of payroll records for its employees, as required by OSD. These policies and procedures should require all employees to complete weekly timesheets signed by the employees and approved by their supervisors documenting hours worked and functions benefited (e.g., program, cost center, contract).

Auditee's Response

In response, LPC officials stated, in part:

> *Two of the three staff members identified in this finding maintain written documentation of their time and attendance. Although it does not appear on a "time sheet," it is still a statement of work that documents time and attendance. In addition, these logs document the duties and functions performed. Furthermore, LPC summarizes these logs to properly allocate these staff members when preparing the UFR.*

Auditor's Reply

We acknowledge that two of the individuals in question did keep some kind of record of the time they worked at LPC. However, as stated in our report, we determined that, contrary to OSD regulations, none of these three individuals submitted timesheets. Rather, the agency's CFO and CEO prepared a statement of work or an employee log of their time that identifies the hours worked on particular tasks, but this record is incomplete and is not submitted as a payroll time and attendance record. We also noted that the agency's Chief of Maintenance does not submit any record of time for weekly payroll processing. Based on this, we again urge LPC to implement our recommendations relative to this audit result.

3. UNALLOWABLE PETTY CASH EXPENDITURES TOTALING $9,510

During our audit period, LPC expended $124,327 from seven petty cash funds. However, we found that LPC had not established adequate controls relative to the administration of these petty cash funds. We reviewed the documentation LPC was maintaining relative to $45,118 of these expenses and found that $43,227 of this amount was either undocumented, inadequately documented, or not related to the activities of LPC's state-funded programs. LPC charged $9,510 of these expenses against its state contracts

As previously noted, 808 CMR 1.05(12) and 808 CMR 1.05(26), promulgated by OSD, define the following as being nonreimbursable program costs:

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

LPC maintains seven different petty cash funds that can be used by its staff for various expenses. These funds, which usually have balances of between $50 and $200, are maintained at LPC's daycare centers and its administrative office. During our audit, we asked LPC officials to provide us with any written policies and procedures they had relative to the administration of these petty cash funds. In response, LPC officials stated that there were no written policies or procedures relative to these accounts.

Based on these internal control deficiencies, we reviewed the documentation LPC was maintaining for all checks written from these petty cash accounts that were in excess of $1,000. This methodology yielded a transaction sample of roughly 36%, or $45,118 ($25,809 in fiscal year 2005 and $19,309 in fiscal year 2006) of the $124,327 expended through these petty cash accounts for the two fiscal years covered by our audit. Based on our audit testing in this area, we found that 96%, or $43,227 of the $45,118 in tested expenditures in our sample were unallowable because they were either not documented, inadequately documented, or appeared to be non-program-related, as indicated in the table below:

Category	Calendar Year 2005	Calendar Year 2006	Total
No Documentation	$ 2,461	$ 2,287	$ 4,748
Inadequate Documentation	14,473	22,532	37,005
Non-Program-Related Expenses	891	583	1,474
Total	$17,825	$25,402	$43,227

Examples of questionable expenditures we identified are as follows:

- An April 27, 2005 petty cash check for $3,111.05 was cashed by LPC's CEO; however, there was only documentation to substantiate $2,411.05 of this expense.
- A July 15, 2005 petty cash check for $2,120 was cashed by LPC's Maintenance Supervisor. The documentation maintained by LPC relative to this expense indicated that these funds were used to pay for staff training. However, there was no documentation identifying who received training or who conducted the training.
- A May 19, 2006 petty cash check for $1,430.89 was cashed by LPC's CEO. The only documentation to support a portion of this expense was a handwritten note on a piece of paper claiming it was used to pay $1,000 for a wall crib and five tables and another handwritten note requesting that "Pat" be paid $50 for computer repairs. Further, $40 of this expense was for gasoline purchased in Brandon, Florida.
- An August 4, 2006 petty cash check for $1,776.16 was cashed by the Maintenance Supervisor. There were documents in the Petty Cash envelope to substantiate $1,164.16 in transactions, but $612 of the $1,776.16 was undocumented.

Regarding this matter, LPC officials contended that all of these expenses were business-related although they could not find all of the documentation to support these expenses.

Recommendation

In order to address our concerns relative to this matter, LPC should amend its fiscal year 2005 and 2006 UFRs and identify the state funds used to pay for these non-program-related expenses, which we calculate to be $9,510 ($43,227 in questionable expenses multiplied by 22%, the average amount of state funding provided during the audit period). Further, LPC should establish adequate controls over the administration of its petty cash funds.

Auditee's Response

In response, LPC officials stated, in part:

> *We respectfully request that the audit report reflect that the insufficiently documented expenses be reclassified as sufficiently documented. All documentation was presented to the auditor but it was still considered unacceptable to him. We did not have policies in place and therefore, do not understand with which policies we were not in compliance.*

Auditor's Reply

During our audit, we requested LPC officials provide us with all the documentation LPC was maintaining relative to the petty cash expenses that were being reviewed. All of the information that was provided by LPC officials was reviewed and analyzed by the audit team to determine whether each expense was reasonable in terms of its being a business expense, adequately documented, and allocable as an expense to a state contract. In a number of instances the audit team identified expenses that, it its opinion, were not adequately documented. For example, LPC may have only had a monthly credit card statement that showed that the expense was incurred but no other documentation to substantiate how it related to the business purposes of LPC. It was therefore both prudent and necessary to identify such expenses as being inadequately documented in our audit report.

In our report, we acknowledge that LPC does not have any policies or procedures relative to its petty cash accounts. Further, our report does not state that LPC was not in compliance with its policies and procedures but rather that it was not in compliance with the specific OSD regulations detailed in this audit result.

4. LPC EXCEEDED THE MAXIMUM OBLIGATION OF ITS STATE CONTRACTS BY $21,005

We found that LPC requested and received reimbursements from EEC that exceeded the maximum obligation of its state contracts by a total of $21,005 for fiscal years 2005 and 2006. According to LPC officials, when EEC and LPC became aware of these overbillings, EEC notified LPC that it could keep these funds and record these revenues as "flexible pool" funding, which EEC provides to human service providers to assist families that have continuity-of-care needs or special transportation/service needs that current contract capacity cannot accommodate. However, LPC did not record this revenue as flexible pool revenue but rather as contract revenue. As a result, LPC overbilled these contracts by $21,005.

We found that during fiscal years 2005 and 2006, LPC requested and received a total of $21,005 in funding from EEC in excess of what was allowed under its state contracts. Specifically, LPC billed EEC for $458,572 in services it provided in its Income Eligible program during fiscal year 2005. However, the maximum obligation of the contract was $445,931, and as such LPC overbilled EEC by $12,641. Similarly, in fiscal year 2006, LPC overbilled EEC for Income Eligible program services by $1,594. During fiscal year 2006, LPC also overbilled EEC for services it provided under its Supportive Service contract with EEC by $6,770. The overbillings in these three programs for the two years under review totaled $21,005.

In regard to these overbillings, on June 27, 2006, EEC's Assistant Director of Contract Resolution sent an email to LPC's Contract Manager instructing LPC to classify any overbillings under its state contract as flexible pool funding, as follows:

> *I talked with [the CFO] to get clarification on her question. [The CFO] is concerned as she is going to be over her max ob [Maximum Contract Obligation] line for preschool after her billing for June 2006. [The CFO] is projecting for next year and was trying to prevent going over her max ob next year in FY 2007. She wanted to know if we thought about increasing the parent [fee] to $4.72. I told [the CFO] that we would not issue another contract based on her projected parent fee for the 260 days. I did explain that the max ob is a projection we correct at year-end through the flex pool. Should you get calls, please help the contractors understand that the max ob is a projection and reconciliation [that] happens each year-end and the flex pool account is used for these types of overages, so there is no need for concern.*

As can be seen from this email, EEC advised LPC officials that any problem with exceeding the maximum obligation of LPC's state contracts is handled through the flexible pool funding process. All flexible pool funding is subject to the availability of funding and budgetary constraints.

The EEC's policies regarding flexible pool funding state, in part:

> *EEC may provide funding through the Flexible Pool to assist families in accessing Income Eligible Child Care when they have continuity of care needs, and/or special transportation or service needs which current contract capacity cannot accommodate. All flex pool funding is subject to the availability of funding and budgetary constraints.*

According to EEC's policies, flexible pool funding is restricted, in part, under four conditions:

> *<u>Continuity of Care</u>*
>
> *Contracted providers that seek flex pool funding to serve children with continuity of care needs may bill the flex pool until a contract slot becomes available. Children in flex pool*

slots for continuity of care purposes must be placed in a contract slot as soon as one becomes available.

Transportation

Children who are eligible for an Income Eligible Contracted Child Care subsidy but cannot attend childcare due to a lack of available transportation may be eligible for transportation funding from the flexible pool. Contracted programs seeking funding to serve such children must submit documentation supporting their request with their monthly billing.

Children with Special Needs

Children with special needs who cannot attend childcare without specific program accommodations may be eligible for funding from the Income Eligible flex pool. Contracted programs seeking funding to serve such children must submit their requests with appropriate documentation to their Regional Policy and Training Advisor for approval.

Foster Parent Support

Income Eligible contracted providers that have received approval from EEC for flex pool funding to enroll foster children referred by the Department of Social Services will continue to bill the flexible pool for the care of these children as long as the children remain in the care of their foster parents, and their foster parents remain eligible.

As noted above, in order to receive flexible pool funding contractors should document their request for these flexible pool funds. However, LPC does not have any documentation that it even submitted a request for flexible pool funding for this $21,005, and LPC cannot document that it provided any additional services that fall within the category covered by flexible pool funding. Rather, LPC recorded this $21,005 as revenue received under the contracts that funded these programs and in so doing exceeded the maximum obligation allowed by these contracts.

Regarding this matter, LPC officials pointed out that its fiscal year is different from the Commonwealth's fiscal year and that LPC does not have procedures to reconcile maximum contract obligation amounts to its contract billings at the end of the Commonwealth's fiscal year (June 30th). Consequently, it is not unusual for LPC to overbill its state contracts. The officials also stated that although EEC had instructed LPC to record the excessive $21,005 as flexible pool funding, LPC instead recorded the excess funds as contract revenues.

Recommendation

EEC should review LPC's contract billings for fiscal years 2005 and 2006 and determine whether it should recover from LPC any of the $21,005 in payments LPC received under its state contracts during our audit period in excess of what was allowed by the maximum obligation of these contracts. In the future, LPC should establish controls ensure that it does not exceed the maximum obligations of any of its contracts. If LPC does provide services in excess of the maximum obligation of a contract, it should seek an amendment to this contract to properly secure funding for these additional services.

Auditee's Response

In response, LPC officials stated, in part:

> *LPC monitors the amount invoiced to EEC with respect to the maximum obligation. Each year, LPC contacts EEC because in at least one of the accounts, LPC will exceed the maximum obligation. EEC consistently instructs LPC to continue to bill for services rendered to clients. They explain that if there is an overage, they (EEC) will use funding from other accounts to cover the balance. LPC provided the maximum obligation reconciliations to the auditor for all fiscal years requested. In addition, we provided documentation of all correspondence with EEC, as noted above. . . .*
>
> *The funding we receive in excess of our maximum obligation is approved in advance and is calculated as follows:*
>
> *Our contract is for a fixed number of slots. We have a non-negotiable rate with EEC. For our income eligible contract, EEC projects what the parents will pay. The contract is written so that EEC will pay the non-negotiable rate less the parent fee, which is then multiplied by the number of service days in the year. When EEC projects a parent fee that is too low, we over bill the contract. For example, if EEC projects a parent fee of $4.72 per day and the non-negotiable rate is $36.00, then the contract will reflect a maximum obligation of $36.00 - $4.72 = $31.28 per day. If there are 261 service days, the total maximum obligation will be $31.28 x 261 = $8,164.08. If we enroll a family and the parent fee is only $2.00 per day, we will bill EEC for $8,874.00, which is $36.00 (non-neg rate) - $2.00 (parent fee) = $34.00 (daily reimbursed rate) x 261 (service days). As you can see, we will over bill the contract in this instance. We did provide all of our invoices to the auditor, which includes documentation of the attendance for all children invoiced. Our invoices reflect that our slots remained full for the entire year and the excessive billing was a result of an incorrect parent fee projection by EEC.*
>
> *It is our understanding that EEC reconciles accounts for all providers in the state in this manner. We contacted EEC again this year and their response was "The Department of Early Education and Care reimburses all child care providers for all services rendered."*

Auditor's Reply

Because LPC recorded this funding as contract revenues it clearly exceeded the maximum obligation of allowed by these state contracts by $21,005. Although LPC may have provided services to clients that entitled it to receive some or all of this $21,005, it did not take the appropriate administrative actions to ensure that these revenues were allowable in accordance with its state contracts. Consequently, we again urge LPC to implement the recommendations we made relative to this audit result.

5. UNALLOWABLE VEHICLE EXPENSES TOTALING $13,559

During our audit period, LPC provided vehicles owned by LPC to its CEO and CFO for their personal use and incurred an estimated $61,634 in expenses associated with these vehicles. However, LPC 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 LPC are unallowable and nonreimbursable under state contracts. LPC charged $13,559 of these expenses against its state contracts. Additionally, we found that LPC did not require these two individuals 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 CEO and CFO.

OSD has promulgated regulations that define certain costs that are unallowable and nonreimbursable under state contracts. In this regard, 808 CMR 1.05(9) identifies the following expenses as nonreimbursable 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 (IRS) and Department of Revenue (DOR) regulations require employers to furnish employees, the IRS, and DOR with accurate wage and earnings 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, LPC allowed two vehicles, a GMC Yukon and a Ford F-150 owned by the agency, to be used by LPC's CEO and CFO, respectively. We determined that, during these two fiscal years, LPC incurred a total of $255,472 in expenses, including depreciation, associated with the operation of all of its vehicles. LPC's accounting records do not identify expenses associated with each specific vehicle. Therefore, in order to determine the expenses associated with the two vehicles in question, we allocated a percentage of the total expenses associated with all of LPC's vehicles to these two vehicles based on the acquisition costs of the vehicles. Accordingly, a total of $61,634 was allocated to these two vehicles.

We reviewed the internal controls that LPC established over the use of these vehicles as well as the documentation of expenses associated with these vehicles. Based on our review, we noted that LPC did not have policies and procedures that required LPC's CEO or CFO to maintain a record of the business and personal use of these vehicles. As a result, these individuals could not provide supporting documentation (e.g., travel logs or work schedules) that documented the business and personal use of these vehicles. Also, the CEO's and CFO's IRS Forms W-2 for calendar years 2005 and 2006 did not include any amount for their personal use of these vehicles, contrary to IRS regulations.

Recommendation

In order to address our concerns relative to this matter, LPC should amend its fiscal years 2005 and 2006 UFRs to properly disclose the $13,559 ($61,634 x 22%) in unallowable vehicle expenses we identified during our audit. In the future, LPC should take measures to ensure that it does not charge any unallowable vehicle expenses against its state contracts.

Auditee's Response

In response, LPC officials stated, in part:

> *We maintain a spreadsheet that has the expenses for each vehicle totaled by month and then year. We do not maintain this detail in our accounting software as the detail is maintained in a spreadsheet. We did not provide this detail to the auditor as it was not requested. . . .*
>
> *In addition, we respectfully request the report to reflect that ALL of the expenses associated with these vehicles are being considered unallowable, although we do, in fact, use the vehicles for business purposes. Both administrators own another vehicle, which they maintain personally.*

Auditor's Reply

Subsequent to the end of our audit fieldwork, agency staff provided us with a spreadsheet that they represented detailed the actual expenses associated with each of the vehicles in question. However, since LPC does not maintain its accounting records in such a manner as to account for the expenses associated with each vehicle, there was no way to substantiate the accuracy of the expenses contained on this spreadsheet. Since none of the employees in question maintains records of the business versus the personal use of these vehicles, it was both necessary and proper for us to question the entire amount of our estimated expenses associated with these vehicles during our audit period.

6. CORPORATE MANAGEMENT STRUCTURE OF LPC DOES NOT PROVIDE ADEQUATE CONTROLS OVER AGENCY OPERATIONS

We found that LPC's overall organizational structure does not provide adequate controls over operations. Specifically, during our audit period LPC's Board of Directors was composed of five individuals, four of whom were related to the agency's CEO. Moreover, three of the four related individuals also held agency positions within LPC. Further, eight of the CEO's family members were employed by LPC during our audit period, and six of these eight individuals were under the direct supervision of another family member. As a result of these internal control weaknesses, we question whether LPC's board is able to perform all of its responsibilities in an effective, efficient, and independent manner. Our specific concerns in this area are discussed below:

a. The Composition of LPC's Board Does Not Facilitate Independent Oversight

All human service providers such as LPC that enter into contracts with the Commonwealth are required to comply with the standards established by the American Institute of Certified Public Accountants (AICPA) as well as Generally Accepted Accounting Principles (GAAP). According to GAAP, entities such as LPC 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. One of the key aspects of the control environment in any organization is the agency's Board of Directors. The Board of Directors of a human service provider is the primary organizational body that ensures LPC meets its operational objectives in the most effective and efficient manner. Board members perform a variety of key functions, including overseeing the overall operation of the agency, setting policies and procedures to ensure that agency objectives are met, and hiring and evaluating the agency's top executive. Chapter 156B, Section 65, of the General Laws identifies the following as being the responsibilities of members of a corporation's Board of Directors:

> *A director, officer or incorporator of a corporation shall perform his duties as such, including, in the case of a director, his duties as a member of a committee of the board upon which he may serve, in good faith and in a manner he reasonably believes to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances.*

Further, the state's Executive Office for Administration and Finance, the Office of the State Comptroller, and the Operational Services Division (OSD) have jointly issued Commonwealth Terms and Conditions for Human and Social Services (General Contract Conditions) with which all contracted human service organizations such as LPC must comply. Regarding an organization's Board of Directors, these General Contract Conditions state:

> *If a non-profit organization, the Contractor shall comply with the principles in the Massachusetts Attorney General's "Guide for Board Members of Charitable Organizations" and with the standards for boards contained in the American Institute of Certified Public Accountants (AICPA)'s statements on auditing standards, as may be amended from time to time. Further, the Contractor specifically agrees that: i) members of the Contractor's management and immediate family (as defined in the AICPA's Financial Accounting Standards Board Statement number 57) will not comprise more than 30% of the voting members of the Contractor's board or any of the board's committees or subcommittees; and, ii) the Contractor's Board of Directors will approve the selection of the Contractor's audit firm, will annually review its executive director's or other more senior manager's performance and set that person's compensation by formal vote, and will meet as frequently as necessary to fulfill the Contractor's obligations under this section. Where the board meets less than two times during its fiscal year, the Contractor shall submit a description of its board structure and the dates of each board and subcommittee meeting with its Uniform Financial Statements and Independent Auditor's Report (UFR).*

Although this section of the General Contract Conditions applies to nonprofit corporations, it does provide a framework for what constitutes an acceptable control environment for all contractors, including for-profit contractors such as LPC, that are doing business with the Commonwealth. We found that, contrary to this framework, LPC's Board of Directors lacked independent members. Specifically, four of LPC's five board members were related to the CEO, and three of these four related board members also held positions in the agency.

Based on this composition, we question the board's ability to perform all of its responsibilities in an independent manner. For example, an agency's Board of Directors has the responsibility for setting the CEO's entire compensation package based on an annual evaluation. However, given the board's composition, the independence of any board evaluation of the CEO's performance is questionable.

b. Corporate Management Structure

The state's Operational Services Division and the Executive Office for Administration and Finance have promulgated a document for fiscal year 2007 under 808 CMR 1.00 entitled UFR Auditor's Compliance Supplement. This document states, in part:

> *However, potential conflict of interest and nepotism situations could exist when employees that set policy and are in a position of responsibility are related to board members. Nepotism is not in keeping with the principles for good internal controls.*

Further, the General Contract Conditions state, in part:

> *The Contractor shall maintain adequate written policies and procedures for accounting, management and personnel activities, including but not limited to conflict of interest and nepotism policies.*

Despite these requirements, we found that LPC had not established a formal written policy relative to nepotism as required by the General Contract Conditions. In fact, during our audit period, eight family members were employed by LPC, and six of those eight individuals were under the direct supervision of another family member without any compensating internal controls to ensure proper, independent supervision. This lack of internal controls could result in inequalities in treatment amongst staff members, particularly in the area of compensation. Regarding this matter, LPC officials stated that LPC was a family-run business and that its board and management are organized accordingly.

Recommendation

In order to address our concerns relative to this matter, we recommend that LPC take measures to develop and implement adequate internal controls over all the governance of its operations consistent with the guidance provided in the General Contract Conditions and OSD regulations

Auditee's Response

In response, LPC officials stated, in part:

> *This finding does not apply to LPC, a for-profit business organized under M.G.L Chap. 156D. While we maintain that we are a family owned and operated business, we do understand that certain policies need to be established. . . .*

Auditor's Reply

We acknowledge that LPC is a family-owned and -operated for-profit organization. As stated in our report, although the cited sections of the General Contract Conditions apply to nonprofit organizations, we believe they provide a framework for what constitutes an acceptable control environment for all contractors, including for-profit contractors such as LPC, who are doing business with the Commonwealth. In this regard, we again recommend that LPC consider implementing our recommendations relative to this issue.

7. INADEQUATE INTERNAL CONTROLS OVER CERTAIN AGENCY OPERATIONS

We found that LPC had not developed and implemented an adequate system of internal controls over certain aspects of its operations. Specifically, we found that LPC did not establish an acceptable cost allocation plan to allocate its indirect costs as required by OSD regulations and did not establish an effective inventory system for its fixed assets. As a result, LPC cannot ensure that all of its indirect costs were properly allocated to its programs or that its inventory of fixed assets is properly safeguarded against loss, theft, or misuse.

According to GAAP, entities such as LPC 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.

However, we found that in addition to the internal control problems we identified (Audit Results Nos. 1-6), LPC had not established adequate internal controls over certain other aspects of its operations. The following is a summary of the additional internal control issues we identified during our audit:

a. LPC Did Not Properly Establish Methods to Pool and Allocate Indirect and Direct Program Costs

The following guidelines regarding the allocation of indirect costs are delineated in OSD's UFR Audit & Preparation Manual*:*

> *Allocation of Program Support expenses…must be made using a written cost allocation plan in accordance with GAAP as described in the sections covering Administration Costs and Costs Which Pertain to Various Functions…. Allocation of Administrative expenses that pertain to the "Overall Direction" of the organization to*

programs...must also be made by utilizing a written costs allocation plan using the same principles as noted above or as described in the Direct Method for allocating indirect costs to federal programs of OMB Circular A-122.

The usage methods recommended by the AICPA guide should be used to allocate the individual expenses that make up administration on line 42 to programs. Usage reports and time studies are utilized when the usage basis is used to determine the amount of time and effort that administrative staff devote to the overall direction of LPC and the extent of benefit (administrative salaries and expenses) derived by fund-raising and program service activities.

When it is not possible to utilize usage reports and time studies, other simplified methods are acceptable for allocating administrative expenses on line 42 as follows:

- *A basis of allocation (allocation percentage) previously established for non-salary expenses that benefit all programs (i.e., centralized telephone system that benefits all programs) is acceptable for expense items other than salaries.*
- *Use of a basis that utilizes experience levels established for salary costs. The executive director's and other administration salaries must be allocated using the percentage of direct care salaries incurred in each program.*

Methods of allocating administrative expenses that utilize budgeted revenue, received revenue, budgeted costs, anticipated contract reimbursements or received contract reimbursements or total program expenses are not acceptable or in accordance with generally accepted accounting principles....

During our audit, we reviewed the accounts that LPC planned to allocate to its program and noted that the agency's accounts did not contain a number of general indirect agency expenses (e.g. telephone services, utilities, office supplies, postage, delivery, mileage for administrative staff). In fact, LPC's Chief Executive Officer's salary and benefits composed the majority of expenses allocated by the agency's Board of Directors during our audit period, while legal, accounting, and nominal items received the remainder of funding. Other administrative expenses were charged to LPC's programs, despite the fact that they were not direct costs to these programs.

We also found that LPC allocates its indirect costs in a discretionary manner to its Infant/Toddler, Preschool, and School-Age programs rather than using an acceptable cost-allocation methodology as required by OSD. Regarding this matter, LPC officials stated that they were unaware of OSD's requirement relative to the allocation of indirect costs.

b. LPC Did Not Maintain an Accurate Inventory System

808 CMR 1.04(5), Inventory of Equipment and Furnishings and Other Goods, states:

Any Contractor in possession of Capital Items, as defined in 808 CMR 1.02 shall label, maintain and keep on file a written inventory of the property in accordance with generally accepted accounting principles. 808 CMR 1.04, promulgated by OSD, states the following with regard to inventory of equipment and furnishings and other goods: "Any Contractor in possession of Capital Items . . . shall maintain and keep on file a written inventory of the property in accordance with generally accepted accounting principles."

However, during our audit we found that LPC did not have a listing of its fixed assets (capital items) in accordance with state regulations. Further, LPC does not routinely conduct a physical inventory of its fixed assets. The lack of a written inventory listing by type, location, amount, and acquisition value for its entire inventory puts LPC and the Commonwealth at financial risk for the replacement cost of these untagged and undocumented items.

In response, LPC's CEO and CFO stated that only the agency's vehicles have been inventoried.

Recommendation

LPC should take measures to ensure that it establishes effective internal controls over all aspects of its operations, including the administration of its indirect costs accumulation and allocation and the inventory of its fixed assets.

Auditee's Response

In response to this audit results, LPC officials provided comments, which are excerpted below:

We do maintain a listing of fixed assets, which was presented to the auditor. Each item is listed by name with the acquisition date, the location and the original purchase price. As we explained to the auditor, we review the listing at year end to be certain that all items are still in use.

Auditor's Reply

During our audit, LPC officials did provide us with two asset listings. One list identified the agency's vehicles and the other listed a freezer and a number of leasehold improvements. Neither of these lists identified the costs of these items or their date of acquisition. Clearly these listings were incomplete and could not be used for inventory purposes. Further agency staff acknowledged that they do not conduct periodic inventories of their assets.