



Commonwealth of Massachusetts
Office of the State Auditor
Suzanne M. Bump

Making government work better

Official Audit Report – Issued August 31, 2011

Merrimack Special Education Collaborative

For the period July 1, 2007 through June 30, 2010



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INTRODUCTION**1**

The Merrimack Special Education Collaborative (MSEC), located in Chelmsford and Billerica, Massachusetts, is an association of 10 local and regional school districts in the Merrimack Valley area known as an “education collaborative.” Education collaboratives are government entities organized pursuant to Chapter 40, Section 4E, of the Massachusetts General Laws. Founded in 1977, MSEC is one of 30 such collaborative associations operating across the state. Each collaborative is governed by a Board of Directors comprising representatives designated by member school committees, as provided by individual collaborative agreements approved by the Commonwealth’s Department of Elementary and Secondary Education (DESE). MSEC’s member districts include the Billerica, Chelmsford, Dracut, Tewksbury, Tyngsborough, and Westford school districts and the Groton-Dunstable, Nashoba Valley Technical, North Middlesex, and Whittier regional school districts. MSEC also provides educational services to multiple non-member districts in northeastern Massachusetts and to certain New Hampshire school districts, and adult vocational services for clients of Massachusetts state agencies such as the Department of Developmental Services (DSS) and the Massachusetts Rehabilitation Commission (MRC). Historically, education collaboratives have primarily provided services for special education students, but they may also provide other services, such as professional development, technology and consultation services, student transportation, and collective purchasing of goods and services for use by participating districts. MSEC reported total revenues of \$19,792,376 for the fiscal year ended June 30, 2010, primarily derived from school district tuition payments. During our audit period, MSEC operated in close association with an affiliated nonprofit corporation called the Merrimack Education Center (MEC). MEC provides management, information technology, maintenance, transportation, and other services to MSEC, and owns facilities leased to MSEC.

Our audit was conducted at the request of the Commissioner of DESE. The scope of our audit included a review and examination of certain aspects of MSEC’s operations during fiscal years 2008 through 2010. However, for certain transactions, it was necessary to expand our audit testing to examine some transactions that occurred outside of our audit period. Our audit scope also included, to the extent possible, a review and examination of various transactions between MSEC and MEC. 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 to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives, which consisted of the following:

1. A review and assessment of the system of internal controls MSEC has established over certain agency operations, and
2. An assessment of MSEC’s compliance with applicable laws, rules, regulations and the terms and conditions of its state contracts and its Collaborative Agreement.

The specific areas reviewed included: tuition payments made by member school districts; budgeting, procurement, and banking practices; credit card expenditures; payroll and personnel time and activity reporting; employee retirement arrangements; payment of student wages; employment contracts; transactions between MSEC and its related-party organization, MEC; state contract administration involving programs funded by MRC, DDS, and the Department of Transitional Assistance (DTA); compliance with DESE requirements regarding teacher licensures, employee evaluations, employee performance development plans, and organizational performance measures; financial and tax filings; and board governance.

Our audit of MSEC was impaired, resulting in scope limitations. A scope limitation occurs when an auditee or another party places restrictions on the scope of the auditor's work. Such restrictions result in the inability to apply all of the audit procedures considered necessary by the auditor in the circumstances of the engagement. During our audit, MSEC impaired our audit work in the follow areas: (1) documentation requested by the audit staff during the audit engagement was either not provided or was incomplete, or there were significant delays in providing the requested information and (2) our access to certain staff was restricted. These impairments significantly limited our ability to conduct our scheduled audit testing. As a result, as noted in this report, it was often not possible to review the records necessary to achieve our audit objectives. Our report's audit results regarding performance and compliance issues reflect these limitations and do not necessarily reflect the full results that might have been obtained had we been provided with all the information we requested.

Based on the audit work that could be performed, we identified over \$26.7 million in inadequately documented and potentially unallowable expenses charged to MSEC by its related-party organization, MEC. We also identified almost \$6.1 million in inadequately documented salary expenses at MSEC and over \$4.3 million in additional expenses that were either undocumented or appeared to be unallowable because they were for non-business-related items such as alcohol, golf, and meals and entertainment. In addition, we found numerous instances in which MSEC appeared not to have complied with various laws, including the state's public bidding laws, finance laws, pension laws, and the open meeting law, as well as state regulations relative to potential conflicts of interest and educator licensure and evaluations. We also found that MSEC did not comply with regulations and guidance issued by state oversight agencies relative to the maintenance of time and activity records and the establishment of the tuition rates it charges for the services it provides. Finally, we also identified numerous other operational deficiencies, including questionable contract administration activities such as understaffing and charging inappropriate expenses to state-funded programs and questionable governance decisions that reduced MSEC's transparency. The specific problems we identified during our audit follow.

AUDIT RESULTS **12**

1. \$21.2 MILLION IN INADEQUATELY DOCUMENTED, QUESTIONABLE, AND POTENTIALLY LEGALLY INVALID RELATED-PARTY TRANSACTIONS **12**

We found that at least as far back as 1991, MSEC entered into contracts with its related-party organization MEC, under which MEC provided various administrative services, facilities, maintenance services, and other items to MSEC. During fiscal years 2008 through 2010, MSEC paid MEC \$21,293,083 for such goods and services. However, based on the limited information MSEC provided to us relative to this contract and the expenses associated with it, we identified a number of problems. First, contrary to the requirements of Chapter 30B of the General Laws, there was no evidence that MSEC used a competitive bid process to procure administrative services, facilities, maintenance services, and other items. According to Section 17(b) of Chapter 30B and interpretive guidelines issued by the state's Office of the Inspector General (OIG), any contract awarded in violation of the law is invalid and no payment can be made. Second, contrary to state regulations and generally accepted accounting principles, MSEC did not properly disclose \$12,557,435 of these related-party transactions in its financial statements. As a result, state funding and oversight agencies did not have the ability to adequately assess MSEC's activities and performance regarding these transactions. Finally, we were not provided with any documentation to substantiate the reasonableness of these expenses, including, but not limited to, administrative service fees totaling \$5,108,285; rent and maintenance charges totaling \$6,763,738; and transportation vehicle charges totaling \$1,605,988 during the audit period. As a result of these deficiencies, there is inadequate assurance that the \$21.2 million in goods and services that MSEC paid to MEC during the audit period was reasonable, proper, or allowable in accordance with state laws and regulations.

2. NO DOCUMENTATION TO SUBSTANTIATE THE REASONABLENESS OF \$5.5 MILLION IN SETTLEMENT AGREEMENT CHARGES TO MSEC BY MEC, WHICH MAY NOT HAVE BEEN PROPERLY AUTHORIZED AND IN COMPLIANCE WITH ITS COLLABORATIVE AGREEMENT **26**

During fiscal year 2006, MSEC entered into a Settlement Agreement with MEC under which MSEC agreed to pay MEC \$5.5 million for various services and the use of facilities provided by MEC during fiscal years 2001 through 2006. This \$5.5 million was in addition to an estimated \$16 million that MSEC had already provided to MEC for the same type of services during this period. During our audit, we asked MSEC officials to provide us with all of the documentation it was maintaining relative to this agreement and the related expenses. Although MSEC provided copies of the minutes for the Board of Directors meeting at which the agreement was approved, it did not provide any documentation for the underlying expenses claimed to have been incurred by MEC. As a result, it could not be determined whether the expenses associated with this transaction were proper and allowable in accordance with state laws and regulations and should therefore have been paid for by MSEC. However, the information we were able to review relative to this agreement raised concerns regarding its execution and legal validity. For example, the required quorum of representatives from what were then MSEC's seven member districts was not present to approve this agreement. Also, all of

the Superintendents who approved this agreement were simultaneously members of both MEC's and MSEC's Board of Directors, which creates a situation in which potential conflicts of interest could arise. In fact, two of the participating Superintendents who voted on this agreement announced their retirement from their school districts (Billerica and North Middlesex Regional) only 25 days after they voted to approve this agreement and then went to work as senior managers for MEC. A third voting Superintendent retired from his school district (Tyngsborough) in 2008 and, as of the end of our audit field work, was working as a senior manager for MEC. Further, this agreement appears to be in violation of MSEC's Collaborative Agreement, which requires all administrative expenses, such as those paid for in this agreement, to be included in MSEC's administrative budget and approved by its board, which was not done in this case.

3. \$3,028,002 IN UNDOCUMENTED AND QUESTIONABLE ADMINISTRATIVE, PROGRAM, AND CREDIT CARD EXPENSES INCURRED BY MSEC AND \$1,292,180 IN EXPENSES IMPROPERLY PROCESSED THROUGH MSEC FOR MEMBER DISTRICTS

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We found a number of problems involving \$4,320,182 in credit card and other administrative and program expenses incurred by MSEC during our audit period. Specifically, MSEC did not provide us with any documentation relative to \$2,514,008 of the expenses that it incurred during this period; therefore, the appropriateness and reasonableness of these expenses could not be determined. For other expenses for which there was documentation, the records that were made available to us either were inadequate to document that expenses were for business-related purposes or showed that the expenditures were clearly questionable in that they included unallowable, non-program-related purchases, including at least \$1,255 for alcohol, which is prohibited by state law; at least \$18,284 for meals and other entertainment such as farewell parties for staff; \$142 for 30 pounds of swordfish for a cookout for Special Education Directors; and at least 37 purchases totaling \$5,735 for golf-related charges. There were also thousands of dollars spent on "retreats" for MSEC and MEC managers. One example of these questionable expenditures is an August 2009 charge of \$1,484 at the Nashua Country Club. This total included \$151 for food, \$359 for alcoholic beverages, and \$974 for golf fees for four people, all of which was treated as administrative conference and meeting expenses. In another example, one MSEC Co-Executive Director charged a total of \$4,576 in vehicle expenses (primarily gasoline for what appears to be a personal vehicle) to MSEC despite the fact that he received a \$500 monthly travel allowance that should have covered these expenses. In addition, we identified approximately \$14,766 in expenditures incurred by MSEC managers that, for unexplained reasons, appeared to have been charged to MEC, and thousands of dollars in MEC-related expenses that were inappropriately paid for by MSEC. However, the documentation being maintained by MSEC relative to these expenses was often too inadequate to identify all the expenses and amounts that were incurred by MEC staff but paid for by MSEC. Finally, contrary to state finance law, MSEC functioned as a fiscal conduit and processed \$1,292,180 in expenditures for three school districts to pay for expenses incurred by individual districts rather than by MSEC.

4. UNDOCUMENTED SALARY EXPENSES TOTALING \$6,055,816 AND QUESTIONABLE PUBLIC SERVICE TIME CREDITED TO MANY MSEC ADMINISTRATORS **48**

Contrary to state regulations and the terms and conditions of its state contracts, MSEC did not maintain records that detail the attendance and time spent on each activity for various salaried employees who during our audit period were paid a total of \$6,055,816. Maintaining this type of information is essential for several reasons. First, because MSEC and MEC have shared employees, it is important to accurately account for these individuals' attendance and activities to ensure that the appropriate agency is charged for their salary expenses. Without such documentation, there is inadequate assurance that all of the \$6,055,816 in compensation expensed by MSEC for these staff members was proper. Second, MSEC is required by DESE program approval requirements and state contract provisions to maintain specific staff levels and ratios. Without attendance/activity records, MSEC has no way of substantiating that it met these staffing requirements. In fact, based on the financial reports that MSEC submitted to the Commonwealth, we found that MSEC did not maintain the staffing levels required by state contracts in at least two of its state-funded programs. Further, without attendance and activity records, MSEC cannot ensure that it accurately reported the time these staff members worked in government service to the appropriate public employee retirement boards. In fact, we found that at least 10 MSEC employees may have inappropriately received credit for time worked in government service in a public employee retirement system to which they may not have been entitled.

5. DEFICIENCIES INVOLVING EDUCATOR PROFESSIONAL STANDARDS AND THE ABSENCE OF ORGANIZATIONAL PERFORMANCE MEASURES **58**

We identified deficiencies in MSEC's systems for ensuring that employees are properly qualified and that DESE requirements applicable to educator licensure, evaluation, and professional development are met. During our audit period, only 30% of MSEC educators were fully licensed. The remaining educators worked under waivers (often not in compliance with applicable waiver conditions) or, in some cases, were working without required waiver approval. Also, contrary to DESE requirements, MSEC's Board of Directors and senior managers had not established employee performance standards, had not conducted required educator evaluations, and had not ensured that new teachers are mentored by properly qualified master educators. Finally, MSEC has not established organizational performance measures needed to promote accountability and attain desired education and service outcomes for MSEC's students and clients.

6. DEFICIENCIES IN PROCUREMENT AND CONTRACT ADMINISTRATION, GOVERNANCE, INTERNAL CONTROLS, BUDGETING AND PRICING, AND FINANCIAL AND TAX REPORTING **70**

Our audit identified deficiencies in a number of areas of MSEC's operations. First, we found numerous instances in which MSEC failed to use competitive procurement practices when procuring goods and services, contrary to state law. We also noted several questionable contract administration activities, such as MSEC's not meeting the contractually agreed-upon staffing requirements in its state-funded programs, allocating hundreds of thousands of dollars in expenses to its publicly funded programs (e.g., an estimated \$997,862 in fiscal year 2009 alone) that were not properly incurred in these programs, and requesting and receiving over \$53,000 in supplemental funding that it did

not need in one state-funded program. Additionally, according to the terms and conditions of state contracts, any subcontract entered into by a contractor must be in writing and authorized in advance by the procuring state agency. Contrary to this requirement, at least \$2,839,982 in contract funding was awarded to MEC during our audit period for services that were actually provided by MSEC without documentation of the required subcontracting approval. We also identified significant governance issues. For example, on March 7, 2007 MSEC amended its Collaborative Agreement to allow the MSEC Board of Directors to amend the Collaborative Agreement without first obtaining approval from member school committees. In our opinion, such governance changes reflect a control environment that is inconsistent with the climate of integrity and transparency essential for effective and accountable government entity operations. We also found instances in which it appears that MSEC did not fully comply with the requirements of the state's open meeting law, had not established adequate internal controls over all of its activities, and was not establishing prices for its services that were consistent with guidelines established by the Department of Revenue's Division of Local Services and the Office of the Attorney General.

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INTRODUCTION

Background

The Merrimack Special Education Collaborative (MSEC), located in Chelmsford and Billerica, Massachusetts, is an association of 10 local and regional school districts in the Merrimack Valley area known as an “education collaborative.” Founded in 1977, MSEC is one of 30 such collaborative associations operating across the state for the purpose of providing education and related services to school districts and their students. Historically, education collaboratives have primarily provided services for special education students, but they may also provide other services, such as professional development, technology and consultation services, student transportation, and collective purchasing of goods and services for use by participating districts. Education collaboratives are government entities organized pursuant to Chapter 40, Section 4E, of the Massachusetts General Laws. Each collaborative is governed by a Board of Directors comprising representatives designated by member school committees, as provided by individual Collaborative Agreements approved by the Commonwealth’s Department of Elementary and Secondary Education (DESE). The statute states, in part:

Two or more school committees of cities, towns and regional school districts and boards of trustees of charter schools may enter into a written agreement to conduct education programs and services which shall complement and strengthen the school programs of member school committees and charter schools and increase educational opportunities for children. ¹

MSEC operates under the control of a Board of Directors composed of Superintendents representing each of the association’s 10 member school committees (see Appendix) and, as such, is an instrumentality of each of its member districts. The Collaborative Agreement also allows MSEC to provide services to non-member districts and to other purchasers of program services such as state human service agencies. With certain exceptions, most services are reimbursed through tuition payments. However, prices for services funded by state human service contracts are established by each individual contract. During the period covered by our audit, MSEC operated the following services:

- A school-district-funded alternative high school located at 114 Turnpike Road, Chelmsford.

¹ The statutory language was amended effective January 19, 2010 to allow charter schools to be members of education collaboratives. Until that date, participation was limited to school committees and regional school districts.

- A school-district-funded alternative middle school with locations at 114 Turnpike Road and 40 Brick Kiln Road, Chelmsford.
- A school-district-funded Pervasive Developmental Disorder (PDD) and Elementary Behavioral School located at 40 Brick Kiln Road, Chelmsford and ancillary sites. Educational programming is provided for students with PDDs such as autism and for others with significant behavioral service needs.
- A school-district-funded Intensive Special Needs Public School Program operating out of 40 Brick Kiln Road, Chelmsford, with multiple classrooms located within public school facilities in member districts. The program serves students for whom education can be provided within a regular school, with some activities integrated with the full public school student population and others provided in separate classrooms used by the program.
- School-district-funded Alternative Vocational High Schools serving students with less severe disabilities or with behavioral or other special educational needs. These schools are located at 248 Boston Street, Topsfield and 80/84 Brick Kiln Road, Chelmsford.
- School-district-funded vocationally oriented education services, including the Center for Occupational Awareness and Placement and School-to-Work services, for students under age 22, primarily with severe disabilities. These services and activities are provided at 40 Linnell Circle, Billerica and other locations.
- Adult vocational services (ages 22 and above) funded by the Commonwealth's Department of Developmental Services (DDS), the Massachusetts Rehabilitation Commission (MRC) and, prior to fiscal year 2009, the Department of Transitional Assistance (DTA). Clients are served both on-site at MSEC facilities (primarily 40 Linnell Circle, Billerica) and through off-site support services in community-based settings.
- A variety of additional non-classroom education-related services provided to school-age students and to school districts and educators on a small scale. These include testing/evaluation services, individual behavioral and home-based services, and an annual Alternative Education Conference.

All school-age education programs operated by MSEC in free-standing school facilities, such as its Alternative Middle School Program, are subject to annual approval by DESE. Similarly, vocational services to adults provided by MSEC are overseen by state agencies such as DDS and MRC.

For fiscal year 2010, MSEC reported 190 full-time equivalent employees and received revenues totaling over \$19.7 million, as detailed on the following page:

Revenue Source*	Amount
Massachusetts Local Government (local and regional school districts)	\$15,963,471
Non-Massachusetts Government Payments (New Hampshire school districts)	1,853,178
Massachusetts State Agency Human Service Contracts (DDS & MRC)	1,149,129
Commercial Revenue (e.g., vocational program work product sales)	550,163
Other Revenue	<u>276,435</u>
Total Revenue	<u>\$19,792,376</u>

*Source: MSEC's audited financial statements and unaudited supplemental schedules for the fiscal year ended June 30, 2010

MSEC's revenue primarily comes from tuition payments charged to both member and non-member districts (including certain New Hampshire school districts) on a student- and program-specific basis. MSEC also derives revenues from the sale of goods and services associated with its vocational training activities. Other, non-tuition-based, revenues include charges to districts for provision of consulting and ancillary services such as one-on-one tutoring and speech or behavioral therapy.

Relationship between MSEC and the Merrimack Education Center, Inc.

During 1966, approximately 20 Merrimack Valley area school districts formed an association to operate a regional center for education and innovation with the approval of the Commonwealth's Department of Education, DESE's predecessor state agency. The association, first known as the "Merrimack Valley Regional Planning Center" and later as the "Merrimack Education Center," was staffed by three career educators, one of whom, a former Wayland school district Superintendent, acted as its Executive Director.

A 1974 case study submitted to the Governor's Commission on School District Organization and Collaboration (a part of the Massachusetts Advisory Council on Education) stated, in part:

In 1970, the last year of the federal grant for the project, the original precursor education collaborative enabling legislation was enacted through chapter 889 of the Acts of 1970, An Act Authorizing School Districts to Enter Into Agreements for the Operation of Model Educational Programs. Under the provisions of that act, incorporated into the Massachusetts General Laws as Chapter 40, section 4E, school districts were authorized to enter into joint agreements to conduct model educational programs, using one district as the "operating agent" on behalf of all participants. Merrimack Education Center remained in operation after the expiration of the original federal grant, using the Chelmsford School District as its operating agent.

In August 1974, the scope of Chapter 40, Section 4E, of the General Laws was expanded to authorize not just "model education programs," but also jointly operated collaborative educational programs. The law required that each collaborative be governed by a board representing all member

districts, using an education collaborative trust fund administered by the largest participating community. The Merrimack Education Center operated as a collaborative pursuant to that law using a renovated home located at 101 Mill Road in Chelmsford, with administrative functions continuing to be provided by the Chelmsford school district.

In August 1976, a subset of the Merrimack Education Center member districts established MSEC, with one of the three principal staff members of the center being designated as the first MSEC Executive Director. The following March, the same three educators incorporated “Merrimack Education Center, Inc.” (MEC) as a nonprofit entity with the original founding former Superintendent from Wayland as its Executive Director and a governing board comprising Superintendents from member districts.

In practice, since their establishment in 1976 through at least October 2009, the two legal entities, MSEC and MEC, operated in tandem, sharing managers and office space at 101 Mill Road. For example, based on records we reviewed, the agency’s name “Merrimack Special Education Collaborative” was rarely used, and the combined organizations were commonly referred to even in their own documents and in public documents of state agencies, local school districts, and other educational organizations as “Merrimack Education Center,” “Merrimack Collaborative,” “Merrimack Education Collaborative,” or “Merrimack Educational Collaborative.” Other documents, such as MSEC job postings and program materials, referred to the collaborative as a division of MEC. State agencies such as the Department of Mental Retardation (now DDS), MRC, and DTA also executed contracts with MEC for direct client services that MEC then had MSEC provide.

During the spring of 2007, the Executive Director of MEC initiated an internal investigation of the MSEC Executive Director, which reportedly resulted in that individual’s suspension and subsequent resignation in July 2007. MEC also filed a complaint with DESE’s educator licensure division, apparently asserting that the terminated MSEC Executive Director had violated professional standards incorporated into DESE’s educator licensing regulations. After the suspension and resignation of the MSEC Executive Director, the “Executive Committee” of MSEC’s Board of Directors voted on September 20, 2007 to appoint two senior associate directors to be “Co-Executive Directors” of MSEC. However at this time, an agreement was entered into between MSEC and MEC to make MSEC “subject to the general management oversight of the MEC

Executive Director and/or designee.” The terms of this agreement remained in place until it was revised in October 2009. Although the revised agreement asserts that the relationship of the parties is that of independent contractors, it specifies that MEC is to provide facilities, maintenance, accounting, payroll, compliance, human resources, IT services, and insurance, and that MSEC’s operating accounts and operating funds, including the deposit of all revenues and payment of all expenses, are to be processed through bank accounts established and maintained by MEC on behalf of MSEC.

The legal basis for MEC’s status as an incorporated nonprofit entity, rather than as an education collaborative government entity, is not clear. In both July 1978 and December 1985 amendments to Chapter 40, Section 4E, required that collaboratives not conforming to then-current provisions of the law be restructured to come into compliance with statutory provisions. However, MEC remained a separate nonprofit entity even though its activities (special education student transportation, educational technology, professional development, and school management/planning consultation services) were generally within the parameters of the collaborative law; its board was controlled by member school superintendents; and its Executive Director simultaneously served as the first President of the Massachusetts Organization of Educational Collaboratives.

History of Relationship between MSEC, MEC, and the Northeast Consortium for Staff Development

MEC and MSEC are also associated with another nonprofit entity, the Northeast Consortium for Staff Development (NCSA). NCSA was established in 1991 as a joint undertaking by approximately 42 Massachusetts school districts, Salem State College (now Salem State University), and the then DOE. NCSA’s Board of Directors and managers included individuals associated with participating districts, the college, DESE, MEC, and MSEC. NCSA’s purpose was to promote the professional development of educators in northeastern Massachusetts, which it did through programs operated in conjunction with MEC and Salem State College. The organization also issued small grants (typically from \$100 to \$2,000 per grantee) for such purposes as sponsoring educators to attend professional conferences. By June 30, 2004, NCSA had accumulated over \$1.9 million in net assets, almost entirely in the form of investment funds. Most of these assets were not needed by the organization, since annual operating costs were less than \$1.5 million and were supported by professional development tuition fees.

Under a court-approved merger/asset transfer agreement, MEC assumed responsibility for NCSD's operations in fiscal year 2005. All funds were transferred to MEC other than limited investment trust fund amounts retained by the NCSD board for the purpose of continuing small grant distributions. By the end of fiscal year 2007 a total of \$1,910,231 had been transferred to MEC and only approximately \$32,000 remained of the NCSD investment trust fund. The NCSD nonprofit entity essentially became inactive at that point, with no grant issuance activity and a Board of Directors comprising only six individuals, including three from non-MSEC member school districts and three associated with MEC and/or MSEC. The NCSD nonprofit entity is still recorded at the Commonwealth's Secretary of State's office as having never been legally dissolved, and the most recent filings for the entity (as of the end of fiscal year 2008) continue to show the books and records as in the care of the MSEC/MEC Chief Financial Officer, with \$32,206 in remaining NCSD net assets. Although NCSD has effectively become inactive, MEC has continued to use "Northeast Consortium for Staff Development" as a program name for some of its professional development services.

Subsequent Events

On April 20, 2011, subsequent to the end of our audit field work, the state's Office of the Inspector General (OIG) issued a letter to the Executive Director of the Massachusetts Teacher's Retirement Board in which the Inspector General questioned the state pension benefits being provided to MEC's Executive Director, who is also MSEC's former Executive Director. In addition, on June 20, 2011 the OIG issued three other letters: one to MEC's Board of Directors detailing various alleged misconduct by MEC's Executive Director; one to MSEC's Co-Executive Directors detailing problems that the OIG identified with the agreements between MSEC and MEC; and one to the Executive Director of the State Board of Retirement, questioning the state pension benefits provided to MSEC's former Director of Public Affairs and Government Issues. Much of the information described in the OIG's letters covered a period of time prior to our audit period and was the result of information the OIG was able to obtain from MEC that MSEC would not provide to us during our audit. The OIG's concerns as presented in these letters are consistent with a number of concerns we identified during our audit.

Audit Scope, Objectives, and Methodology

The scope of our audit, which was conducted at the request of the Commissioner of DESE, included a review and examination of certain aspects of MSEC's operations during fiscal years 2008 through 2010. However, for certain transactions, it was necessary to expand our audit testing to examine some transactions that occurred outside of our audit period. Our audit scope also included, to the extent possible, a review and examination of certain transactions between MSEC and one of its affiliated entities, MEC. 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 to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives, which consisted of the following:

- A review and assessment of the system of internal controls MSEC has established over certain agency operations, and
- An assessment of MSEC's compliance with applicable laws, rules, and regulations and the terms and conditions of its state contracts and its Collaborative Agreement.

The specific areas reviewed included the following:

- Tuition payments made by member school districts
- Budgeting, procurement, and banking practices
- Expenditures for program services, to vendors, on credit cards and those made for the purposes of employee reimbursements
- Payroll and personnel, including time and activity reporting, employee retirement arrangements, payment of student wages, and employment contracts
- Transactions between MSEC and its related-party organization, MEC
- State contract administration involving programs funded by MRC, DDS, and DTA
- Compliance with DESE requirements regarding teacher licensures, employee evaluations, employee performance development plans, and organizational performance measures
- Financial and tax filings
- Board governance

To achieve our objectives, we first reviewed applicable laws, rules, regulations and other guidance relative to education collaborative activities that have been issued by various state agencies. We then spoke with officials from DESE and MSEC to obtain an understanding of how MSEC operates and the control environment at MSEC during our audit period. We also met with representatives from two private accounting firms retained by MSEC to conduct the annual audits of the agency for fiscal years 2008, 2009, and 2010 and reviewed some of the work conducted by these firms during their audits. However, due to the limitations placed on us by these accounting firms on the information we could review, we did not rely on the work of these accounting firms for the purposes of planning and conducting our audit. We examined financial, personnel, and program records to determine whether expenses incurred by MSEC during our audit period were reasonable; allowable; allocable; properly authorized and recorded; and in compliance with applicable laws, regulations, and grant and contract requirements. A description of the nature and extent of our audit testing in each area is described in detail in each of the audit results contained in this report. We also examined certain documentation available from other sources such as MEC filings with the Secretary of State's Corporations Division and its filings with the Office of the Attorney General's (OAG) Public Charities Division, including the Form PC required by the OAG, accompanying copies of audited financial statements, and Internal Revenue Service Form 990 filings.

The Office of the State Auditor (OSA) is authorized by its enabling legislation, Chapter 11, Section 12, of the General Laws, to perform audits of both governmental entities and of state contractors to “determine compliance with the provisions of the contract or agreement, the grant, and the laws of the Commonwealth.” This statute further mandates that “the state auditor shall have access to such accounts at reasonable times and said department [OSA] may require the production of books, documents, vouchers, and other records relating to any matter within the scope of such audit” and also provides that “such audits shall be conducted in accordance with the standards for audits of governmental organizations, programs, activities, and functions published by the Comptroller General of the United States.” In addition, other provisions of state and federal laws, regulations, executive orders, and contract provisions authorize the OSA to conduct audits on behalf of DESE and other state oversight and purchasing agencies. In this regard, 808 Code of Massachusetts Regulations (CMR) 1.04(8), Access and Examination of Records, a regulation applicable to contracted human services, states, in part:

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

Finally, the above-referenced governmental audit standards promulgated by the Comptroller General of the United States state, in Section 7.35 of Government Audit Standards:

Avoiding interference with investigations or legal proceedings is important in pursuing indications of fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse. Laws, regulations, or policies might require auditors to report indications of certain types of fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse to law enforcement or investigatory authorities before performing additional audit procedures. When investigations or legal proceedings are initiated or in process, auditors should evaluate the impact on the current audit. In some cases, it may be appropriate for the auditors to work with investigators and/or legal authorities, or withdraw from or defer further work on the audit engagement or a portion of the engagement to avoid interfering with an investigation.

Our audit of MSEC was impaired, resulting in scope limitations. A scope limitation occurs when an auditee or another party places restrictions on the scope of the auditor's work. Such restrictions result in the inability to apply all of the audit procedures considered necessary by the auditor in the circumstances of the engagement.

Impairments and resulting scope limitations encountered during our audit included the following:

1. Documentation requested by the audit staff during the audit engagement was not provided, including the following:
 - a. Expenditure documentation such as invoices and receipts for credit card transactions for approximately \$2.5 million in expenditures recorded in MSEC's accounting records during the audit period
 - b. Documentation of the underlying actual costs relative to a \$5.5 million settlement agreement between MSEC and MEC in 2006
 - c. Documentation of the underlying actual costs for approximately \$21.2 million in charges from MEC to MSEC for administrative service fees, rent, maintenance, transportation, depreciation, vehicle insurance, and employee fringe costs during the three-year audit period
 - d. Certain personnel, compensation, and time and activity documentation, particularly for individuals working in programs funded by state contracts or across multiple programs, or individuals working for/providing services to both MSEC and MEC
 - e. All documentation pertaining to the NCSD nonprofit entity

- f. Certain documents, including utilization and revenue projections, pertaining to budgeting and pricing activity
 - g. Various documents pertaining to MSEC's contract administration activities
2. We also experienced significant delays in obtaining some documentation. For example, we requested that MSEC provide us with an electronic version of its general accounting ledger. Although we were provided with a manual version of this record at the beginning of our audit, we did not receive the electronic version we requested until approximately four months after our initial request. Moreover, we found that the electronic version of this document was incomplete in that it did not contain information relative to MRC and DTA contracts for services provided by MSEC, which totaled at least \$601,853 during fiscal years 2008 and 2009. Moreover, even where documentation was provided to us, it was often insufficient to determine whether expenditures such as those for food, gas, clothing, and sporting goods, were for legitimate organizational purposes.
 3. In certain instances, MSEC management provided only photocopies of certain documents. Where original documentation is not provided, there is an increased risk for irregularities such as the alteration of documents in an attempt to either conceal information or convince auditors that required documents were in place for the audit period when they were not. For example, invoices for legal services were provided only as photocopies, with essential information redacted regarding the details of services for which MSEC was being charged.
 4. Both MSEC and MEC restricted our access to certain staff.
 5. Access to information being maintained by two of the private accounting firms that conducted MSEC's annual financial audits during our audit period was also partially restricted. When we met with audit firm representatives, they informed us that attorneys for MSEC and MEC had imposed restrictions on the information to be provided to us. In the case of the firm responsible for MSEC's fiscal year 2010 audit, we were allowed to visually inspect workpapers but were not allowed to make photocopies without prior authorization from the attorneys. For the second accounting firm, which had been responsible for audits of MSEC for fiscal years 2008 and 2009, we were only provided with photocopies of the records that we requested that were heavily redacted. For example, all references in these documents relative to transactions between MEC and MSEC had been blacked out. Representatives from the accounting firm informed us that the restriction on providing unredacted workpaper copies to our audit staff had been imposed by attorneys for MEC.

These impairments significantly limited our ability to conduct our scheduled audit testing. As a result, as noted in this report, it was often not possible to review certain matters necessary to achieve our audit objectives and to perform all appropriate procedures to determine the existence or extent of possible fraud, illegal acts, or abuse involving MSEC, its employees, and related entities and individuals. Our report's audit results regarding performance and compliance issues reflect these limitations and do not necessarily reflect the full results that might have been obtained had we been provided with all of the information we requested.

Based on the audit work that could be performed, we identified over \$26.7 million in inadequately documented and potentially unallowable expenses charged to MSEC by its related-party organization, MEC. We also identified almost \$6.1 million in inadequately documented salary expenses at MSEC and over \$4.3 million in additional expenses that were either undocumented or appeared to be unallowable because they were for non-business-related items such as alcohol, golf, and meals and entertainment. In addition, we found numerous instances in which MSEC appeared to have not complied with various laws, including the state's public bidding laws, finance laws, pension laws, and the open meeting law, as well as state regulations relative to potential conflicts of interest and educator licensure and evaluations. We also found that MSEC did not comply with regulations and guidance issued by state oversight agencies relative to the maintenance of time and activity records and the establishment of the tuition rates it charges for the services it provides. Finally, we also identified numerous other operational deficiencies, including questionable contract administration activities, such as understaffing and charging inappropriate expenses to state-funded programs, and questionable governance decisions that reduced MSEC's transparency. The specific problems we identified during our audit follow.

AUDIT RESULTS

1. \$21.2 MILLION IN INADEQUATELY DOCUMENTED, QUESTIONABLE, AND POTENTIALLY LEGALLY INVALID RELATED-PARTY TRANSACTIONS

We found that at least as far back as 1991, the Merrimack Special Education Collaborative (MSEC) entered into contracts with its related-party organization, the Merrimack Education Center (MEC), under which MEC provided various administrative services, facilities, maintenance services, and other items to MSEC. During fiscal years 2008 through 2010, MSEC paid MEC \$21,293,083 for such goods and services. However, based on the limited information MSEC provided to us relative to this contract and its associated expenses, we identified a number of problems. First, contrary to the requirements of Chapter 30B of the Massachusetts General Laws, there was no evidence that MSEC used a competitive bid process to procure these administrative services, facilities, maintenance services, and other items. According to Section 17(b) of Chapter 30B and interpretive guidelines issued by the state's Office of the Inspector General (OIG), any contract awarded in violation of Chapter 30B is invalid and no payment can be made. Second, contrary to state regulations and generally accepted accounting principles, MSEC did not properly disclose \$12,557,435 of these related-party transactions in its financial statements. As a result, state funding and oversight agencies did not have the ability to adequately assess MSEC's activities and performance in terms of these transactions. Finally, we were not provided with any documentation to substantiate the reasonableness of these expenses, including, but not limited to, administrative service fees totaling \$5,108,285; rent and maintenance charges totaling \$6,763,738; and transportation vehicle charges totaling \$1,605,988 during the audit period. As a result of these deficiencies, there is inadequate assurance that the \$21.2 million in goods and services that MSEC paid to MEC during the audit period was reasonable, proper, or allowable in accordance with state laws and regulations.

We found that MSEC entered into contracts, which beginning in fiscal year 2007, were entitled Administrative Services and License Agreements (ASLAs) with MEC under which MEC provides MSEC with various administrative services, facilities, maintenance services and other items. Although it was not clear when the first agreement was executed, the fiscal year 2007 ASLA that was provided to us references a 1991 ASLA that was terminated at the end of fiscal year 2006. The ASLA executed for fiscal year 2007, effective for a 10-year period commencing July 1, 2006, required MSEC to pay MEC for facility usage at a rate of \$16 per square foot

annually with annual adjustments for inflation. Under this ASLA, MSEC is also required to pay MEC for building improvement costs, payroll services, information technology (IT) services, human resource services, compliance services (e.g., tax and retirement filings), worker compensation insurance premiums, administrative staff services, general liability insurance premiums, accounting services, and casualty insurance premiums with respect to personal property. Other items that MSEC is required to pay under this agreement include legal costs, utility costs, and repair and maintenance expenses. Further, the ASLA includes the following provision:

If there are expenses or services which are not identified in this Article VI, but which are, in fact, furnished or otherwise provided, each expense or service shall be either a Direct Expense or an Allocated Expense as the parties shall, from time to time, agree, and, absent such agreement, as fairly determined by MEC.

No prices were established in association with the provision of the aforementioned services and other items other than the rent rate and interest rates associated with any loans or building improvements. All service billings and revenues were to be processed through MEC. In addition, the agreement stated:

Certain employees of MEC also furnish services to MSEC, and certain employees of MSEC also furnish services to MEC. Each such employee shall receive directly from MEC and MSEC such salary and benefits as are determined by each of them.

In October 2009, prior to its scheduled June 2016 expiration, the ASLA was renegotiated, and certain provisions were modified, including elimination of the language authorizing employees to furnish services across entity lines and an increase in the facility rental rate to \$23 per square foot.

The following table summarizes the expenses that were incurred by MSEC relative to the ASLA that was in effect during our audit period.

	Fiscal Year 2008	Fiscal Year 2009	Fiscal Year 2010	Total*
Administrative Service Fee	\$1,786,484	\$2,013,450	\$1,308,351	\$5,108,285
Rent	1,169,000	1,307,000	2,443,129	4,919,129
Maintenance	546,500	670,500	627,609	1,844,609
Transportation	519,218	530,144	556,626	1,605,988
Fringe Reimbursement	1,592,195	1,706,001	547,979	3,846,175
Payroll Processing Fees	13,059	6,107	1,190	20,356
Telephone/Communications	46,616	35,875	593	83,084
Training Programs	-	-	72,900	72,900
Indirect Charge	1,735,014	1,900,087	-	3,635,101
Other	-	77,456	80,000	157,456
Total	<u>\$7,408,086</u>	<u>\$ 8,246,620</u>	<u>\$5,638,377</u>	<u>\$21,293,083</u>

Source: MSEC financial records

* The summary totals appearing in the above table exclude payments of additional expenses, such as those for utilities expenses and miscellaneous credit card expenditures.

During our audit, we identified numerous problems with these expenses, including (a) a non-competitive procurement process, (b) undisclosed related-party transactions totaling \$12,557,435, and (c) a lack of documentation to substantiate the reasonableness of related-party transactions, as discussed below.

a. Non-Competitive Procurement

As a government entity functioning as an instrumentality of its member school districts, MSEC is subject to Chapter 30B of the General Laws, commonly referred to as the state's Uniform Procurement Act. According to a Chapter 30B implementation guide issued by the state's Office of the Inspector General (OIG) the law, enacted in 1990, is based on certain premises, including:

Uniform contracting procedures promote competition and fairness. Chapter 30B clarified and demystified local contracting for vendors competing for contracts and for citizens observing the process. . . . Fair, robust competition for larger procurements saves money and promotes integrity and public confidence in government.

In accordance with this statute, a contract totaling \$25,000 or more over the life of the agreement must, pursuant to Section 5 of the statute, be publicly procured through a competitive, sealed-bid process. Further, this statute requires that full documentation of the

procurement process be maintained in a formal, publicly available procurement file for at least six years after the date of final payment under the contract. According to the OIG implementation guide, any contract awarded in violation of this law is invalid and no payment can be made even if supplies have been delivered, work has been performed, and all parties have acted in good faith.

The ASLA between MSEC and MEC for fiscal year 2007 that we reviewed was originally to remain in effect for 10 years, but was superseded by a revised ASLA executed between the MEC Executive Director and the two MSEC Co-Executive Directors on October 15, 2009, with a retroactive effective date of July 1, 2009. There was no documentation that any of the items provided under this ASLA or the prior agreements had been competitively procured in accordance with Chapter 30B. As a result, according to the guidelines published by the OIG, these agreements may not be legally valid. Further, due to a lack of competitive procurement, there is also no guarantee that the public interest was served such that MSEC obtained the best possible price for these goods and services. This concern is exacerbated by the fact that, given the relationship between MSEC and MEC, the ASLAs do not represent arms-length transactions and therefore present a higher risk for abuse. For example, the ASLA executed at the start of fiscal year 2007 was signed by the then-Superintendent of the Westford school district on behalf of MSEC and by the then-Superintendent of the Billerica school district (also a MSEC board member) on behalf of MEC. Similarly, when the ASLA was revised in October 2009 it was negotiated and signed by MSEC's two Co-Executive Directors, both of whom had also worked for and been compensated by MEC.

b. Undisclosed Related-Party Transactions Totaling \$12,557,435

Transactions made under arrangements such those between MEC and MSEC are referred to by accounting and auditing standards as "related-party transactions." Related-party situations are of special concern for auditors, funders, and oversight agencies since the use of related parties may facilitate the misappropriation of assets; fraud; or violations of law, regulation, policy, or contract requirements and may be used to generate undue benefit to individuals or to other entities, particularly in situations where relationships and transactions are not fully disclosed to oversight agencies or parties providing funds to the organization. Due to these concerns, federal and state laws, regulations, and accounting standards have

been established to control the use and reporting of related-party arrangements. Depending on the circumstances, multiple standards, definitions, and regulations apply; however, the primary standard that applies to these types of situations is the Financial Accounting Standards Board's Statement of Financial Accounting Standards (SFAS) No. 57, which defines a related party as follows:

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

As noted in the Background section of this report, in addition to the tuition revenues it receives from its member and non-member school districts, MSEC also receives over \$1 million annually in funding under contracts with state human service agencies and is therefore subject to certain state regulations. In this regard, OSD, the agency responsible for regulating and overseeing the administration of human services, has promulgated regulations with which all contracted human service providers such as MSEC must comply. In addition to promulgating regulations, OSD has published various documents that provide guidance to organizations such as MSEC that provide human services and their private accounting firms on how to assess an entity's compliance with applicable laws and regulations. Disclosure of related-party relationships is mandated by 808 Code of Massachusetts Regulations (CMR) 1.04(4), and further guidance is provided in the Uniform Financial Statement and Independent Auditor's Report (UFR) Auditor's Compliance Supplement, which 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.

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

If, after a hearing, DPS [now OSD] finds a violation of 808 CMR 1.04(4), 1.04(5) or 1.05, DPS may order that the contract(s) directly affected by such violation be terminated or may assess a civil penalty of not more 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), 1.04(5) or 1.05, DPS may debar the Contractor for a period not to exceed five years.

In the notes to its financial statements, MSEC consistently identifies MEC as a related party, which therefore makes the entities subject to OSD's regulations relative to related-party transactions. However, we found that, contrary to the aforementioned related-party transaction disclosure requirements, during our audit period MSEC disclosed only \$8,735,648 of its total related-party transactions of \$21,293,083 in its financial statements, leaving \$12,557,435 undisclosed, as detailed below:

Summary of Related-Party Transactions Disclosed in MSEC Financial Statements

July 1, 2007 through June 30, 2010

	Fiscal Year 2008	Fiscal Year 2009	Fiscal Year 2010	Total
Administrative Services	\$1,786,484	\$2,013,450	\$1,308,351	\$5,108,285
Rent, Repair, and Maintenance	-	-	3,070,737	3,070,737
Transportation	-	-	556,626	556,626
Other Expenses Charged by MEC	-	-	-	-
Total	<u>\$1,786,484</u>	<u>\$2,013,450</u>	<u>\$4,935,714</u>	<u>\$8,735,648</u>

Summary of Undisclosed Related-Party Transactions

July 1, 2007 through June 30, 2010

	Fiscal Year 2008	Fiscal Year 2009	Fiscal Year 2010	Total
Administrative Services	\$ -	\$ -	\$ -	\$ -
Rent, Repair, and Maintenance	1,715,500	1,977,500	-	3,693,000
Transportation	519,218	530,144	-	1,049,362
Other Expenses Charged by MEC	<u>3,386,885</u>	<u>3,725,526</u>	<u>702,662</u>	<u>7,815,073</u>
Total	<u>\$5,621,603</u>	<u>\$6,233,170</u>	<u>\$702,662</u>	<u>\$12,557,435</u>

As a result of MSEC's not properly disclosing all of these related-party transactions, state funding and oversight agencies did not have the ability to adequately assess MSEC's activities and its performance as they relate to these transactions.

c. No Documentation to Substantiate the Reasonableness of Related-Party Transactions

One principle applicable to related-party transactions is that, even where such transactions are legal and fully disclosed, assertions that such transactions represent "fair market value" must be viewed with skepticism. Instead, the accepted criterion is that charges should not exceed the lowest of three amounts: (a) the fair market value if that can be reasonably determined, (b) the actual cost incurred by the related party, or (c) the actual cost the purchaser would have incurred had the goods or services been owned or operated directly by the entity, rather than through the related party. As previously noted, because MSEC received state funding under human service contracts, it must comply with regulations promulgated by OSD regarding related-party transactions. In this regard, 808 CMR 1.05(8) promulgated by OSD defines the following costs as being unreasonable and therefore nonreimbursable under state contracts:

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

Although this OSD regulation provides certain exceptions, we saw no evidence that the MSEC/MEC related-party transactions met the criteria for treatment as an exception. In addition, regardless of whether a related-party relationship exists, 808 CMR 1.05(16) defines management agency fees, such as those charged by MEC, as nonreimbursable if they exceed the cost a contractor would have incurred had it not entered into a management agreement.

During our audit, we attempted to assess the reasonableness of the transactions between MSEC and MEC. Specifically, we requested from MSEC officials all documentation pertaining to all related-party charges made by MEC to MSEC during our audit period. Our objective was to determine whether these expenses were reasonable, allowable, allocable, and properly authorized and recorded in accordance with accounting and auditing standards. However, as previously noted, in many cases, requested documentation was either not provided or was not sufficient for us to make these determinations. Nevertheless, we were able to identify certain problems based on the information that was provided to us that

clearly raise questions about the appropriateness and reasonableness of many of these ASLA expenses, as discussed below.

Transportation

The ASLA between MEC and MSEC did not specify that MEC was to provide transportation services to MSEC. However, during our audit period, MEC billed and received payments from MSEC totaling \$1,605,988 for the use of passenger vans owned by MEC and for related vehicle depreciation and insurance charges. These vehicles were used by MSEC primarily to transport students and adult clients in state-contracted programs. For the years prior to fiscal year 2010, we were not provided with any documentation other than entries in MSEC's accounting records showing charges for "goodwill transportation assessment" and for vehicle depreciation and insurance. These charges totaled \$519,218 for fiscal year 2008 and \$530,144 for fiscal year 2009, with no documentation of the number or type of vehicles assigned to MSEC programs. In fiscal year 2010, MEC charged MSEC \$556,626 in transportation costs on the basis of daily rates for each day of vehicle usage. However, MSEC did not provide us with any documentation showing how these daily vehicle usage charges had been established, and there was no formal, written service contract between the two entities for these services that clearly identifies each party's duties and responsibilities. In response to our requests, MSEC officials provided us with fiscal year 2010 information on the rates charged by MEC, the number of vehicles available on a daily basis, and the number of days charged, which was based on the number of program days in the period rather than on the number of days each vehicle was actually used. However, without records such as vehicle usage logs or documentation of the actual costs incurred by MEC in providing the vehicles to MSEC, it was not possible to perform audit procedures necessary to confirm that rates were reasonable or whether MSEC might have been able to either provide its own transportation services or procure these services through another transportation provider at a lower cost. Further, the lack of vehicle usage logs and access to MEC transportation program documentation prevented us from determining whether these transportation service arrangements were also free from abuse. For example, it could not be determined whether more vehicles were provided than were necessary or whether the vehicles in question were being shared by both MSEC and MEC and, if so, whether MSEC was paying for a disproportionate amount of the costs associated with these vehicles.

Facility Rent

The ASLA stated that MEC would be renting facility space to MSEC and specified the number of square feet used by MSEC for each facility and a charge per square foot to be adjusted each year based on changes in the federal Consumer Price Index. However, there was no documentation to substantiate that MSEC used a competitive bidding process to procure the use of this space, and we were not provided with any documentation regarding the underlying costs incurred by MEC for this space or how the square footage rental rate was established. Consequently, there was inadequate assurance that MSEC rented space at the lowest possible cost or that the rental payments MEC was receiving for this space were reasonable and allowable in accordance with state regulations. The rental rate for fiscal year 2007 was \$16 per square foot. However, under the new ASLA, the fiscal year 2010 rental rate was increased by 43.75% to \$23 per square foot (far in excess of the 3.52% increase in the Consumer Price Index over this same period) without any explanation. In addition, our review of floor plans coupled with our observations during our facility visits raised questions regarding the reasonableness of the amount of space that was being charged to MSEC.

Administrative Fees and Reimbursements

As previously noted, 808 CMR 1.05 (16) promulgated by OSD identifies the following as being nonreimbursable costs:

(16) Management Agency Fees. Fees charged to the Contractor by a management agency which exceed the costs the Contractor would have incurred had it not entered into a management agreement.

During our audit period, MSEC paid administrative fees to MEC totaling \$5,108,285. The ASLA does not detail the basis on which these fees are to be calculated or the costs that will be used in establishing these fees. Further, the ASLA contains no details on what MEC staff will be used to provide any of the administrative services that may be included in these fees or the compensation they will be paid.

During our audit, we asked MSEC officials to provide us with all the documentation it was maintaining relative to these fees, including information on the costs included in the fee and how the fee rate was established. Although MSEC is paying this fee, MSEC officials told us that MEC had the information we requested and, as previously noted, MEC would not provide us with this information. We were also not provided with any documentation to

substantiate that MSEC used a competitive bidding process to procure these services or any documentation regarding the underlying costs incurred by MEC for these services. Consequently, it was not possible to determine whether all of these administrative expenses were necessary and reasonable in accordance with state regulations or whether MSEC had the ability to either perform these services itself or procure these services from another vendor at a lower cost.

We also analyzed MEC's financial statements and Internal Revenue Service (IRS) Form 990 filings for 2010, and concluded that the ASLA payments from MSEC were the funding source for MEC's compensation for its senior managers. Given the high salaries for these individuals, it is difficult to conceive how MSEC would not be able to operate these services itself at a lower cost. Specifically, MEC's top administrators receive significantly higher compensation than that provided to MSEC's top administrative staff. For example, during calendar year 2010, MSEC's Co-Executive Directors each received compensation totaling approximately \$150,000 each from MSEC. However, according to MEC's public disclosures, during calendar year 2010 at least four of MEC's administrative staff received over \$200,000 in compensation, with MEC's Executive Director receiving \$517,162 in compensation from MEC.

Maintenance Expenses

The amount of various maintenance expenses provided under the ASLA also appear to be questionable. For example, even where accounting records produced by MSEC's private accounting firms indicated that certain maintenance costs were directly associated with a specific MEC program, a portion of the costs were expensed to MSEC. However, given the limited amount of documentation were able to obtain relative to these expenses it was not possible to determine an accurate amount that MSEC was overcharged for these services.

Recommendation

During our audit, we identified a number of significant problems, including the non-competitive procurement of many of the items included in the ASLA, that raise serious concerns about these related-party transactions, which we believe warrant further investigation. Consequently, we recommend that MSEC immediately discontinue making payments under the ASLA. Further, DESE and OSD, in conjunction with other oversight agencies such as the OAG, should

conduct a review of the expenses that have been paid by MSEC under this and previous ASLAs and take whatever actions they deem appropriate to resolve these matters. This resolution should include a determination on the amount of funds that should be recovered by MSEC from MEC and returned to MSEC's member communities and state contracting agencies. Further, in the future, MSEC should take measures to ensure that it can provide all of its own administrative services and that any goods or services that it has to purchase are procured in accordance with the requirements of Chapter 30B of the General Laws. MSEC should also ensure that it properly discloses all related-party transactions and maintains documentation to substantiate the reasonableness of all of its transactions.

Auditee's Response

In response to this issue, MSEC officials provided the following comments:

For more than four decades, MSEC has provided special education students and individuals with high quality facilities, creative programs and an effective learning environment. Throughout this time period, MSEC maintained a relationship with MEC. Beginning in the late 1970s, MEC provided certain administrative services to MSEC and a license to use certain real property owned by MEC. That an educational collaborative had a relationship with a non-profit entity for these purposes was not atypical in Massachusetts, and MSEC is not aware of any statute, regulation or guideline that would suggest anything improper about such a relationship. Indeed, MSEC's co-executive directors understand that there are other educational collaboratives in Massachusetts that currently maintain relationships with non-profit entities whereby administrative services and use of facilities are provided.

For many years, MEC provided the collaborative these administrative services and the use of certain facilities under somewhat informal agreements and understandings and practices and policies that dated back to the infancy of the entities' relationship. In 2006, however, MSEC and MEC executed an Administrative Services and License Agreement (the "2006 ASLA"). While MSEC believed at that time it was in its best interest to continue to obtain the same administrative services and to use the facilities owned by MEC as it had for several years, MSEC was advised that a more formal agreement which memorialized the terms, conditions, rights and obligations of each entity was needed. The 2006 ASLA was written and prepared by attorneys at the law firm Seyfarth Shaw LLP. The 2006 ASLA was presented in its substantial form to the MSEC Board of Directors during a June 5, 2006 Board meeting, at which these attorneys opined that it was "imperative that an agreement delineating the exchange of goods and services" be approved by the MSEC Board.

The current members of MSEC's Board of Directors and MSEC's co-executive directors are not aware of any records from this time period that raise any issues or concerns with respect to the arrangement contemplated -- and subsequently implemented -- by the 2006 ASLA. For example, there is nothing to suggest that legal counsel ever advised MSEC during this time period that there possibly could be an issue, legal or otherwise, with this contractual arrangement. Similarly, MSEC's auditors who conducted annual audits of MSEC for the fiscal years ending 2006 through 2009, also never raised any potential issues within its management letters, financial audit statements or financial performance reports with this contractual arrangement.

During the time period of the OSA's audit, MEC furnished services to the collaborative under the 2006 ASLA and a 2009 ASLA, including but not limited to payroll services (payroll processing, tax return filing and fees, 1099 and W-2 preparation and filing), compliance services (filing with federal and state agencies, tax authorities and retirement plans), human resource services (compliance with appropriate state and federal agencies, benefit analysis, enrollment and monitoring in all benefit and retirement plans, unemployment services and retirement plan management), and technology services. MSEC currently is in the process of reviewing the 2009 ASLA in general and the provision of these services by MEC in particular.

In the recent past, MSEC's co-executive directors have utilized a best business practice procedure that attempted generally to track the formal requirements of Chapter 30B of the Massachusetts General Laws. MSEC currently is in the process of reviewing its purchasing policy to make revisions and ensure compliance as necessary.

Since 2009, MSEC has taken significant steps to further separate and delineate its respective activities and actions from MEC. For example, prior to January 1, 2010, MSEC and MEC maintained a joint operating bank account, with a separate accounting of each organization's activities maintained on the general ledger system. MSEC now maintains a separate bank account from which all payments must be approved in writing by MSEC's co-executive directors. MSEC also operates on separate financial databases, accounting systems and ledgers. MSEC no longer shares the same independent auditor as MEC. As explained further below, this accounting firm -- which MSEC retained for its fiscal year 2010 independent audit -- also continues to advise MSEC with respect to the amendment, adoption and implementation of certain policies and procedures at the collaborative. MSEC also has engaged and is represented by separate legal counsel.

Transportation for fiscal 2010 was based on number of days available, not actual usage. Transportation usage currently is under review at MSEC, including without limitation the adoption of an agreement for use of specific vehicles or related services and specific rates charged.

In addition to the significant and ongoing changes to its contractual relationship with MEC, MSEC also has taken practical steps to affirm publicly that it is a separate entity. First, by way of example, there is not a single member of the MSEC Board of Directors who also serves as a member of the MEC Board. There is no longer any overlap between the memberships of the two entities' Boards.

Due to events subsequent to the end of the OSA audit field work, MSEC has undertaken additional steps to review and consider its future relationship with MEC. . . .

In June 2011, MSEC ceased making payments under the 2009 Administrative Services and License Agreement. MSEC's future relationship with MEC currently is under review and consideration by MSEC's Board of Directors.

MSEC's co-executive directors are in the final stages of researching administrative office staff positions, gathering data from MSEC member school districts and other collaboratives, and developing job descriptions for an internal business manager, director of human resources and/or payroll clerk position. The MSEC Board of Directors has requested budget and other information for its review and consideration. Such information will be presented to the Board of Directors for a formal vote authorizing the creation of these positions internally at MSEC and the salary levels for each approved position.

MSEC currently is in the process of reviewing its purchasing policy to make revisions so as to ensure it is compliant with Chapter 30B of the Massachusetts General Laws.

With respect to third party disclosures, in fiscal year 2010, MSEC expanded from fiscal year 2009 and 2008 financial statements to include all material related party transactions. The majority of the fiscal 2010 "undisclosed" costs were fringe benefits for MSEC employees paid through the preexisting joint bank account maintained by MEC prior to the full separation of bank accounts and policies from MEC. With full separation of financial accounts, and the expanded disclosures, future related party transactions will be properly disclosed.

MSEC is in the process of reviewing and revising its policies and procedures, including its record keeping and record retention policies.

Auditor's Reply

Our report does not state that it is improper for a collaborative to have a business relationship with a nonprofit entity. However, if this relationship is with a related party, as in the case of MEC and MSEC, it is essential that the collaborative's management establish adequate controls to ensure that all transactions between the two entities are conducted in a fair and equitable manner in compliance with all applicable laws, rules, and regulations. During our audit, we found that MSEC had not established such controls and that, accordingly, many of the transactions between MSEC and MEC appeared to be questionable, improper, and potentially illegal.

In its response, MSEC asserts that over the years, MEC has furnished various goods and services to MSEC. However, as stated in our report, despite our requests, MSEC officials did not provide us with most of the documentation we requested relative to the services MEC provided to MSEC during our audit period. Consequently, it was not possible for the OSA to conduct the testing necessary to substantiate the reasonableness of any of the payments MSEC made for these services. However, based on the documentation the OSA was able to obtain and analyze, the OSA identified a number of significant issues relative to these payments, as detailed in this report.

MSEC does not directly dispute our conclusions relative to this issue but states that the current members of its Board of Directors and MSEC's Co-Executive Directors are not aware of any records from this time period that raise any issues or concerns with respect to the ASLA. We cannot comment on why MSEC's accounting or law firms did not raise concerns about the ASLA. Given the impairment to our ability to review various records, it was not possible to determine the scope of work provided by MSEC's law firm to establish whether the services provided by this law firm included a review of the issues that the OSA identified relative to the ASLA as well as other previous service agreements. Further, it is possible that MSEC's

accounting or law firms may have expressed some concerns relative to these agreements that were not brought to our attention, given our limited access to MSEC records. In any case, it is clearly the responsibility of MSEC's management and not an outside entity to ensure that all agency transactions are conducted in accordance with applicable laws, rules, and regulations. In our opinion, it is unconscionable for MSEC management to not ensure that it complied with all applicable laws, rules, and regulations when procuring these goods and services

In its response, MSEC states that its Co-Executive Directors have utilized what it calls a "best business practice procedure that attempted generally to track the formal requirements of Chapter 30B of the Massachusetts General Laws." However, we were not provided with any documentation to substantiate this assertion, and we identified numerous procurements that were not conducted in accordance the requirements of Chapter 30B. Moreover, in these instances the "best business practice" clearly would have been for MSEC to comply with the requirements of Chapter 30B, since it is statutorily required to do so.

MSEC asserts that during the audit period, MEC furnished various services to MSEC and that it is in the process of reviewing the provision of these services by MEC. We cannot comment on MSEC's assertion regarding what services were provided by MEC because, as previously noted, MSEC did not provide us with most of the information we requested relative these services. However, it is clear that, given the problems we identified relative to the ASLA as detailed in our report, rather than assessing the provision of services by MEC, MSEC should discontinue using MEC to provide these services.

MSEC states that "Since 2009, MSEC has taken significant steps to further separate and delineate its respective activities and actions from MEC." However, given that these two organizations have always been separate legal entities, one has to question why they operated in this manner in the first place. Moreover, the fact that both organizations operated essentially as the same organization does not mitigate MSEC's responsibility to its member districts and to the taxpayers of the Commonwealth to ensure that it operates in the most economical and efficient manner and in compliance with all applicable laws, rules, and regulations.

Based on its response, MSEC is taking some measures to address our concerns relative to this matter. However, we again recommend that DESE and OSD, in conjunction with other oversight agencies such as the OAG, conduct a review of the expenses that have been paid by

MSEC under this and previous ASLAs and take whatever actions they deem appropriate to resolve these matters. This resolution should include a determination on the amount of funds that should be recovered by MSEC from MEC and returned to MSEC's member communities and state contracting agencies.

2. NO DOCUMENTATION TO SUBSTANTIATE THE REASONABLENESS OF \$5.5 MILLION IN SETTLEMENT AGREEMENT CHARGES TO MSEC BY MEC, WHICH MAY NOT HAVE BEEN PROPERLY AUTHORIZED AND IN COMPLIANCE WITH ITS COLLABORATIVE AGREEMENT

During fiscal year 2006, MSEC entered into a Settlement Agreement with MEC under which MSEC agreed to pay MEC \$5.5 million for various services and the use of facilities provided by MEC during fiscal years 2001 through 2006. This \$5.5 million was in addition to an estimated \$16 million that MSEC had already provided to MEC for the same type of services during this period. During our audit, we asked MSEC officials to provide us with all of the documentation it was maintaining relative to this agreement and the related expenses. Although MSEC provided copies of the minutes for the Board of Directors meeting at which the agreement was approved, it did not provide any documentation for the underlying expenses claimed to have been incurred by MEC. As a result, it could not be determined whether the expenses associated with this transaction were proper and allowable in accordance with state laws and regulations and therefore should have been paid for by MSEC. However, the information we were able to review relative to this agreement raised concerns regarding its execution and legal validity. For example, the required quorum of representatives from what were then MSEC's seven member districts was not present to approve this agreement. Also, all of the Superintendents who approved this agreement were simultaneously members of both MEC's and MSEC's Board of Directors, which creates a situation in which potential conflicts of interest could arise. In fact, two of the participating Superintendents who voted on this agreement announced their retirement from their school districts (Billerica and North Middlesex Regional) only 25 days after they voted to approve this agreement and then went to work as senior managers for MEC. A third voting Superintendent retired from his school district (Tyngsborough) in 2008 and, as of the end of our audit field work, was working as a senior manager for MEC. Further, this agreement appears to be in violation of MSEC's Collaborative Agreement, which requires all administrative expenses, such as those paid for in this agreement, to be included in MSEC's administrative budget and approved by its board, which was not done in this case.

Under its Settlement Agreement with MEC, MSEC agreed to pay MEC \$5.5 million for various services and the use of facilities provided by MEC during fiscal years 2001 through 2006. At the time the Settlement Agreement was approved, MSEC and MEC also executed the previously discussed ASLA. The net effect of the charges MSEC had to pay MEC from these two agreements was a transfer of at least \$8,238,555 from MSEC to MEC during fiscal year 2007 alone. As a result of the two agreements, coupled with other financial operating results, MSEC's net assets were reduced from \$3,830,137 at the beginning of fiscal year 2006 to a negative \$2,415,129 at the end of fiscal year 2007. In contrast, the net assets of MEC increased from \$4,615,620 to \$14,604,410 over the same period. Details of these changes are shown in the following table:

Merrimack Special Education Collaborative and Merrimack Education Center

Net Asset Changes *

	MSEC	MEC
Fiscal Year 2006 Beginning Net Assets	\$3,830,137	\$4,615,620
Fiscal Year 2006 Ending Net Assets	(\$623,469)	\$10,966,773
Fiscal Year 2007 Ending Net Assets	(\$2,415,129)	\$14,604,410
Total Change in Net Assets through Fiscal Year 2007	(\$6,245,266)	\$9,988,790
Change Amount Associated with Settlement and Administrative Service Fees	(\$8,238,555)	(\$8,238,555)
Total Net Asset Change Attributable to Other Factors	\$1,993,289	\$1,750,235

*Source: Audited financial statements for each organization

The executed Settlement Agreement includes the following explanation for why MEC was entitled to these retroactive payments:

MEC recognizes that it has been dilatory in asserting its claim against MSEC

MSEC recognizes that its ability to accumulate a surplus of net assets as of June 30, 2006, of approximately \$4,600,000 (Four Million Six Hundred Thousand Dollars) arises almost exclusively from MEC providing services and facilities below MEC's actual cost of services and fair rental value of the facilities provided. . . .

Both parties recognize that it is important that this matter be resolved at this time, so that henceforth, the provisions of the Administrative Services Agreement will govern, and both parties will thereby be treated fairly.

The agreement specified amounts for various expense types, such as personnel, payroll, building improvements, and rent. Expenses for fiscal year 2006 were stated to be “to some extent an estimate.” However, no explanation was provided for other category amounts on the schedule, including “Legal,” Advertising, “Conferences & Meetings,” “Consultants,” “Materials & Supplies,” and “Furniture & Equipment.” Further, according to documentation we reviewed, MEC initially claimed that MSEC owed MEC \$7,416,262 for unpaid services and facility use for the period of time in question, asserting that those claim amounts were net of payments already made by MSEC to MEC for the period. Although MEC’s initial claim was for approximately \$7.4 million, the actual executed agreement provided for MSEC to pay MEC \$5.5 million in full settlement of the claim, payable in seven installments totaling \$4 million on June 30, 2006 and \$250,000 on June 30th in each succeeding year through June 30, 2012. MSEC officials did not provide us with an explanation for why the amount changed, and we were not provided with any itemization as to what constituted the \$5.5 million final settlement amount.

Since MSEC was still making Settlement Agreement payments during the period covered by our audit, we determined that it would be necessary and appropriate to examine the Settlement Agreement arrangements and the underlying cost documentation for the \$5.5 million in charges. During our audit, we asked MSEC officials to provide us with all the documentation the agency was maintaining relative to this agreement. However, MSEC staff did not provide us with any of the requested information other than minutes for the Board of Directors meeting at which the agreement was approved. As in other instances, MSEC officials told us that the responsibility for providing this documentation rested with MEC and was beyond MSEC’s control. As a result, it was not possible to substantiate the reasonableness of any of the \$5.5 million in charges associated with the Settlement Agreement. However, based on other records we were able to obtain, including MEC’s Internal Revenue Service Form 990s, Massachusetts Public Charities Division filings, and information gathered from MSEC personnel files, board minutes, and the audit workpapers maintained by the private audit firm responsible for auditing MSEC’s and MEC’s financial statements for fiscal year 2006, we were able to identify certain concerns relative to the Settlement Agreement, as follows:

Questionable Activities Relative to the Approval of the Settlement Agreement

The Settlement Agreement was approved at a June 5, 2006 MSEC Board of Directors meeting attended by five school district Superintendents, all of whom voted to approve the agreement, which was subsequently executed by the Executive Directors of MEC and MSEC. However, our analysis identified concerns relative to this approval process, as follows:

- The terms of MSEC's Collaborative Agreement require that a majority of voting members be present to constitute a quorum. At the time the Settlement Agreement was executed, seven school districts comprised MSEC's official membership: Billerica, Chelmsford, Dracut, Groton-Dunstable Regional, Tewksbury, Tyngsboro, and Westford. However, only three of the seven districts (Billerica, Chelmsford, and Tyngsborough) were represented by their school Superintendents at this meeting. The other two participating Superintendents in attendance represented the North Middlesex Regional and Stoneham school districts, neither of which had formally joined MSEC at that time, and Collaborative Agreement documents covering those districts had not been executed or approved by their school committees, committees for the actual MSEC member districts or the DESE Commissioner as required by Chapter 40 of the General Laws. In fact, the North Middlesex Regional School District did not become a legally recognized member of MSEC until August 2007, and the Stoneham School District never became a legal member of MSEC. Consequently, only three of the five votes cast for this Settlement Agreement were legitimate, and the required quorum of representatives from four of MSEC's seven member districts was not present.
- Chapter 268A of the General Laws governs the conduct of all public employees, including those working for education collaboratives. This statute prohibits public employees from not only engaging in conflict-of-interest situations but also even giving the appearance of being involved in a conflict-of-interest situation. However, all five of the voting Superintendents at this meeting were simultaneously members of MEC's Board of Directors. Since MEC stood to receive a substantial financial benefit from the approval of this agreement, this vote clearly represents a potential conflict-of-interest situation for the involved Superintendents. In fact, two of the five participating Superintendents who voted on this agreement had previously announced their retirement from their school districts (Billerica and North Middlesex Regional) effective June 30, 2006, only 25 days after the vote. Both eventually went to work as senior management employees for MEC. A third voting superintendent (from Tyngsborough) retired in 2008 and as of the end of our audit field work was working as a senior manager for MEC. Further, the MSEC Executive Director executing the agreement on behalf of the collaborative was also simultaneously employed as the MEC Deputy Executive Director, thereby raising a question as to whether a conflict-of-interest situation existed.

The above circumstances raise concerns regarding both the appropriateness and legal validity of the approval of this settlement agreement.

Variances in the Summary of Claims Relative to the Settlement Agreement

During our review of the records being maintained by the private accounting firm that conducted the fiscal year 2006 audits of MSEC and MEC, we noted that the audit firm had been provided with a different version of the Settlement Agreement than the version that was provided to us during our audit. Specifically, the copy of the Settlement Agreement provided to the private audit firm presented a total of only approximately \$6.5 million in claims, rather than the \$7.4 million in claims appearing on the version provided to us by MSEC management and the \$5.5 million actually agreed to in the final agreement. No explanation for the variances appeared in any of the available documentation. A summary of the differences between the amounts presented to us and MSEC's accounting firm appears in the following table:

Questionable Variances in MEC's Asserted Claim Amounts*

Charge Category	Version Presented to OSA	Version in Private Audit Firm Workpapers	Variance
Personnel, Payroll, Accounting, Etc.	\$2,987,834	\$3,207,922	\$220,088
Legal	11,905	11,905	-
Advertising	47,322	47,322	-
Conferences and Meetings	38,558	38,558	-
Consultants	36,187	36,187	-
Materials and Supplies	219,004	219,004	-
Rent	1,796,081	1,931,901	135,820
Furniture and Equipment	833,578	490,817	(342,761)
Building Improvements	<u>1,445,793</u>	<u>479,289</u>	<u>(966,504)</u>
Total	<u>\$7,416,262</u>	<u>\$6,462,905</u>	<u>\$(953,357)</u>

*In addition to the consolidated variances summarized here for the six-year period, significant variances also existed category for each fiscal year and for the total for each fiscal year.

Because MSEC failed to provide requested documentation underlying the Settlement Agreement amounts, it was not possible to conduct further audit procedures to examine the above claim amounts and determine the reasons for the identified variances.

Undocumented Charges of \$16 Million Used to Calculate the Settlement Agreement

It is important to note that the amounts detailed in the Settlement Agreement were apparently in addition to over \$16 million in payments MSEC had already made to MEC for the covered period. Since the Settlement Agreement stated that the claim amounts were net of payments already made by MSEC to MEC for the period, we attempted to conduct audit procedures to confirm that such adjustments had actually been made. However, the failure of MSEC and MEC to provide requested documentation prevented us from performing those procedures. We did perform an analysis of MEC and MSEC financial statement information covering the settlement claim period, as well as an analysis of corresponding MEC Internal Revenue Service Form 990 filings for those years. Our analysis of these documents indicated that, in addition to the above-presented claim amounts, MSEC may have paid as much as \$14,612,167 to MEC for payroll/fringe costs, so-called “overhead charges,” maintenance reimbursements, and rent, as well as additional amounts for client transportation services and various other items. Although client transportation charges were generally not identifiable from financial statement and IRS Form 990 documents, separate information appearing in supplemental financial schedules filed with the Commonwealth’s Operational Services Division indicates that MEC may have charged MSEC an additional \$1,786,272 for vehicle usage during fiscal years 2002 through 2006. Based on these estimates, we believe that the Settlement Agreement charges were in addition to at least an estimated \$16,398,439 in charges already imposed by MEC for the six-year period covered by the agreement. In the absence of full documentation, MEC’s assertion that claim amounts were actually net of the substantial payments already made by MSEC could not be verified.

Potential Noncompliance with MSEC’s Collaborative Agreement

We noted that the Settlement Agreement disregarded specific provisions of the MSEC Collaborative Agreement. Specifically, the MSEC Collaborative Agreement in place for fiscal years 1989 through 2007 included the following language specific to administrative costs:

All M.S.E.C. administrative costs shall be shared equally by each of the seven participating municipalities. These costs will be included in the administrative budget approved by the Collaborative Board. The administrative budget shall be approved on or before December 15th for the next fiscal year beginning on July 1st.

As previously discussed, the Settlement Agreement claim amounts were for administrative costs such as personnel, payroll, accounting, human resources, technology, and legal expenses subject to MSEC’s Collaborative Agreement requirement for prior budgeting and approval. In the

absence of the requested underlying documentation for settlement agreement costs, it was not possible to determine whether these claim amounts had been properly budgeted and pre-approved as required by MSEC's Collaborative Agreement.

MEC's Assertion That It Provided Services and Facilities Below Its Actual Cost and Fair Rental Value of the Facilities Is Questionable

MEC's assertion in the Settlement Agreement that it had been providing services to MSEC at below actual cost is inconsistent with information presented in MEC's own audited financial statements. We examined MEC's publicly filed audited financial statements for fiscal years 2001 through 2006. As summarized in the table below, MEC's own financial disclosures showed that, even excluding the effect of the Settlement Agreement, MEC had generated a \$2,963,294 (3.9%) surplus for the six-year period. In fact, during this six-year period, none of MEC's individual activities experienced a loss. Moreover, although not detailed in the following table, we also found that a surplus had been generated for the organization as a whole for each fiscal year.

Summary of MEC Statement of Activities Information

July 1, 2000 through June 30, 2006

	Revenue	Expense	Net Revenue
Technology/Planning Services	\$35,730,065	\$35,135,336	\$594,729
General and Administrative Services	15,213,818	14,476,539	737,279
Transportation Services	10,892,128	10,562,386	329,742
Professional Development Services	9,186,870	9,173,746	13,124
Special Programs	3,331,031	2,746,971	584,060
Grants	1,527,924	1,527,924	-
Other (unidentified)	<u>704,360</u>	<u>-</u>	<u>704,360</u>
Total Prior to Settlement Agreement	\$76,586,196	\$73,622,902	\$2,963,294
Settlement Agreement Amount Reported as Fiscal Year 2006 Administrative Service Fee	<u>831,000</u>	<u>-</u>	<u>831,000</u>
Total Excluding Settlement Agreement Amount for Fiscal Years 2001 through 2005 Treated as a Net Asset Transfer	<u>\$77,417,196</u>	<u>\$73,622,902</u>	<u>\$3,794,294</u>

Change in Net Assets due to Operations Excluding Fiscal Year 2006 Settlement Agreement Revenue	\$2,963,294
Change in Net Assets due to Fiscal Year 2006 Settlement Agreement	831,000
Change in Net Assets due to Settlement Agreement Asset Transfer	4,669,000
Change in Net Assets due to Fiscal Year 2005 NCSD Asset Transfer	<u>1,572,406</u>
Total Change in Net Assets	\$10,035,700
Beginning Net Assets as of July 1, 2000	<u>931,073</u>
Ending Net Assets as of June 30, 2006	<u>\$10,966,773</u>

As can be seen in the preceding table, rather than providing these services at cost, MEC made significant profits on the General and Administrative Services it provided to itself and MSEC during the period in question. Further, in MEC's publicly filed audited financial statements, it reported no expense whatsoever for the \$831,000 portion of the Settlement Agreement that had been recognized as administrative service fee revenue for fiscal year 2006, which seems to indicate that this amount was pure profit. However, since requested documentation such as MEC's accounting records were not made available, it was not possible for us to complete appropriate audit procedures necessary to determine the extent to which the \$5.5 million in Settlement Agreement charges was reasonable.

Recommendation

During our audit we identified a number of significant problems involving the approval of this Settlement Agreement and potential conflict-of-interest situations that we believe warrant further investigation. Consequently, we recommend that MSEC immediately discontinue making payments under the Settlement Agreement. Further, DESE and OSD, in conjunction with other oversight agencies such as the OAG, should conduct a review of the expenses that have been paid by MSEC under this Settlement Agreement and take whatever actions they deem appropriate to resolve this matter. This resolution should include a determination of the amount of funds that should be recovered by MSEC from MEC and returned to MSEC's member communities and state contracting agencies. In the future, MSEC should ensure that it maintains documentation to substantiate the reasonableness of all of its transactions.

Auditee's Response

In response to this issue, MSEC officials provided the following comments:

For many years, MEC provided MSEC administrative services and the use of certain facilities under somewhat informal agreements and understandings and practices and policies that dated back to the infancy of the entities' relationship. In 2006, MSEC and MEC executed a Settlement Agreement (the "2006 Settlement Agreement"). The 2006 Settlement Agreement was written and prepared by attorneys at the law firm Seyfarth Shaw LLP. The 2006 Settlement Agreement was presented in its substantial form to the MSEC Board of Directors during a June 5, 2006 Board meeting, at which these attorneys were present.

The current members of the Board of Directors and MSEC's co-executive directors are not aware of any records from this time period that raise any issues or concerns with respect to the claims settled by the 2006 Settlement Agreement. For example, there is nothing to suggest that legal counsel ever advised MSEC during this time period that there possibly could be an issue, legal or otherwise, with this settlement agreement. Similarly, MSEC's auditors who conducted annual audits of MSEC for the fiscal years ending 2006 through 2009, also never raised any potential issues within its management letters, financial audit statements or financial performance reports with this settlement agreement.

Due to events subsequent to the end of the OSA audit field work, MSEC has undertaken additional steps to review and consider its relationship with MEC.

Furthermore, MSEC's Board of Directors also intend to review the MSEC's Articles of Agreement. Such a review will commence in the current fiscal year. . . .

MSEC has ceased making payments under the 2006 Settlement Agreement.

MSEC is in the process of reviewing and revising its policies and procedures, including its record keeping and record retention policies.

Auditor's Reply

In its response, MSEC states that "For many years, MEC provided MSEC administrative services and the use of certain facilities under somewhat informal agreements and understandings and practices and policies that dated back to the infancy of the entities' relationship." In our opinion, this statement is concerning in that it indicates that for many years prior to our audit period, the internal controls in place were not adequate to ensure the integrity of these transactions, which is precisely the reason why the OSA believes that these transactions, which occurred beyond our audit period, should be further investigated.

MSEC's response does not directly dispute our conclusions relative to this issue but rather asserts that MSEC's current board members and its Co-Executive Directors are not aware of any records from this time period that raise any issues or concerns with respect to the claims settled by the 2006 Settlement Agreement. However, our audit clearly identified a number of significant

issues relative to this agreement that should have been known and addressed by MSEC's management and its board members. For example, the required quorum of representatives from what were then MSEC's seven member districts was not present to approve this agreement. Also, all of the Superintendents who approved this agreement were simultaneously members of both MEC's and MSEC's Board of Directors, which creates a situation in which potential conflicts of interest could arise. Further, this agreement appears to be in violation of MSEC's Collaborative Agreement, which requires all administrative expenses, such as those paid for in this agreement, to be included in MSEC's administrative budget and approved by its board, which was not done in this case. In our opinion, conducting a related-party transaction in this manner was irresponsible on behalf of MSEC's management and raises serious concerns about the propriety of the transaction.

Based on its response, MSEC is taking some measures to address our concerns relative to this issue. However, we again recommend that DESE and OSD, in conjunction with other oversight agencies such as the OAG, should conduct a review of the expenses that have been paid by MSEC under this Settlement Agreement and take whatever actions they deem appropriate to resolve this matter. This resolution should include a determination of the amount of funds that should be recovered by MSEC from MEC and returned to MSEC's member communities and state contracting agencies.

3. \$3,028,002 IN UNDOCUMENTED AND QUESTIONABLE ADMINISTRATIVE, PROGRAM, AND CREDIT CARD EXPENSES INCURRED BY MSEC AND \$1,292,180 IN EXPENSES IMPROPERLY PROCESSED THROUGH MSEC FOR MEMBER DISTRICTS

We found a number of problems involving \$4,320,182 in credit card and other administrative and program expenses incurred by MSEC during our audit period. Specifically, MSEC did not provide us with any documentation relative to \$2,514,008 of the expenses that it incurred during this period; therefore, the appropriateness and reasonableness of these expenses could not be determined. For other expenses for which there was documentation, the records that were made available to us were either were inadequate to document that the expenses were for business-related purposes or showed that the expenditures were clearly questionable since they included unallowable, non-program-related purchases, including at least \$1,255 for alcohol, which is prohibited by state law; at least \$18,284 for meals and other entertainment, such as farewell parties for staff; \$142 for 30 pounds of swordfish for a cookout for Special Education

Directors; and at least 37 purchases totaling \$5,735 for golf-related charges. There were also thousands of dollars spent on “retreats” for MSEC and MEC managers. One example of these questionable expenditures is an August 2009 charge of \$1,484 at the Nashua Country Club. This total included \$151 for food, \$359 for alcoholic beverages, and \$974 for golf fees for four people, all of which was treated as administrative conference and meeting expenses. In another example, one MSEC Co-Executive Director charged a total of \$4,576 in vehicle expenses (primarily gasoline for what appears to be a personal vehicle) to MSEC despite the fact that he received a \$500 monthly travel allowance that should have covered these expenses. In addition, we identified approximately \$14,766 in expenditures incurred by MSEC managers that, for unexplained reasons, appeared to have been charged to MEC and thousands of dollars in MEC-related expenses that were inappropriately paid for by MSEC. However, the documentation being maintained by MSEC relative to these expenses was often too inadequate to identify all of the expenses and amounts that were incurred by MEC staff but paid for by MSEC. Finally, contrary to state finance law, MSEC functioned as a fiscal conduit and processed \$1,292,180 in expenditures for three school districts to pay for expenses incurred by individual districts rather than by MSEC.

According to MSEC’s financial records, in addition to the expenses it incurred relative to the ASLA and Settlement Agreements discussed in Audit Results No. 1 and No. 2, during the period July 1, 2007 through June 30, 2010, MSEC also incurred \$6,808,410 in other non-salary-related expenses. During our audit, we reviewed all of the documentation MSEC was maintaining relative to these expenses and identified problems with \$4,320,182 of these expenses, as detailed in the following table and discussed in the following sections:

	FY 2008	FY 2009	FY 2010	Total
Missing Documentation	\$743,262	\$780,345	\$990,401	\$2,514,008
Redacted/Questionable Legal Invoices	-	5,353	185,659	191,012
Questionable Credit Card Expenditures	53,182	45,446	24,938	123,566
Other Questionable/Inadequately Documented MSEC Expenditures	23,120	53,802	107,728	184,650
MSEC Expenditures Charged to MEC	6,878	6,875	1,013	14,766
Fiscal Conduit Expenditures:				
Chelmsford	342,568	390,952	390,622	1,124,142
Westford	106,179	38,859		145,038
Billerica	6,000	6,000	11,000	23,000
Subtotal Fiscal Conduit Expenditures	<u>454,747</u>	<u>435,811</u>	<u>401,622</u>	<u>1,292,180</u>
Total	<u>\$1,281,189</u>	<u>\$1,327,632</u>	<u>\$1,711,361</u>	<u>\$4,320,182</u>

Missing Documentation

During our audit, we requested that MSEC officials provide us with all documentation relative to the \$6,808,410 in non-salary-related costs that were documented in the agency's accounts for the period July 1, 2007 through June 30, 2010 other than those detailed in Audit Results No. 1 and No. 2. Based on our review of these records, we determined that there was no documentation to substantiate \$2,514,008 of these expenses. The amount of documentation that was missing varied by vendor. For some, documentation for all the transactions that were recorded in MSEC's accounting records was missing, whereas for others, documentation was present for some but not all transactions. The types of transactions associated with this missing documentation varied widely, such as utility, cleaning, education supply, gas card, telephone and other utilities, and credit card charges. The absence of documentation for these expenses impaired our ability to conduct our audit testing in this area.

Inadequately Documented and Questionable Expenditures

Based on the documentation that was made available to us relative to \$1,806,174 in other non-salary-related expenses, we identified a number of problems, as described in sections (a) through (e) that follow:

a. Redacted and Questionable Legal Invoices

During our audit period, MSEC employed an individual to function as its full-time legal counsel. During fiscal year 2008, outside legal costs totaled only \$329, and there were only \$4,841 in outside legal costs for the first 11 months of fiscal year 2009. However, for fiscal year 2010 and the last month of fiscal year 2009, MSEC's accounting records recorded \$191,329 in expenses for outside legal services provided by four different law firms. Given the significant increase in these legal expenses, we attempted to review the documentation MSEC was maintaining relative to these expenses. However, MSEC would provide us only with redacted invoices for \$180,745 of these expenses, and documentation for \$10,267 of the remainder of these expenses was not sufficient to provide assurance that these legal expenses were reasonable, necessary, and proper or that the disclosures that MSEC included in its financial statements during our audit period relative to any legal proceedings were accurate. As a result, a total of \$191,012 in legal expenses was determined to be questionable.

b. Questionable Credit Card Expenditures Charged to MSEC

For an expenditure by a public entity such as MSEC to be reasonable and allowable, it must be both reasonable and incurred for a public purpose within the scope of expenditures authorized for the entity by law and its governing board and funding and oversight agencies. Oversight agencies, including the OAG and the Department of Revenue's Division of Local Services (DLS), have issued guidance on the permissible parameters for such expenditures. A DLS publication (City and Town, Volume 19, No. 2) issued in February 2006 provides a detailed discussion of these matters and a summary of applicable statutes and case law, such as Massachusetts Supreme Judicial Court rulings. The DLS guidance states that public funds can only be used for proper public purposes and can provide no more than incidental, minor benefits to individuals in limited situations where the expenditure advances both public and private interests. This standard requires public entities to employ conservative practices with respect to allowable expenses, such as the use of private rather than public funds for retirement parties, allowance of only minor gratuities (e.g., under \$50 in value) to individuals such as retirees, and the provision of only minimal refreshments at meetings to keep participants alert and to avoid loss of time and disruption if participants leave the premises (e.g., for election workers at polling stations). For example, funding of modest lunches should be permitted only in conjunction with all-day meetings. The guidance also references the prohibition on the purchase of alcoholic beverages established by Chapter 44, Section 58, of the General Laws.

Although MSEC had not established its own credit card accounts, through the end of fiscal year 2010, MEC established such accounts for use by both MSEC and MEC employees. Based on our review of MSEC's accounting records, we identified that at least 17 credit cards were used for transactions expensed to MSEC. Twelve were assigned to MSEC programs or managers, including one card to each of MSEC's Co-Executive Directors and the joint MSEC/MEC Chief Financial Officer. Based on entries in MSEC's financial records, it appears that five additional cards were assigned to MEC managers but were also used for transactions charged to MSEC.

In its guidance, DLS stresses the importance of appropriate policy and procedural controls at each government entity. However, we found that MSEC had not established adequate internal controls, including formal written policies and procedures, relative to the use of

collaborative credit cards. Moreover, the control environment was such that, as detailed below, the very managers responsible for developing and implementing such controls had incurred or approved many of the questionable transactions we identified. In addition, in some instances Superintendents and other officials of school districts responsible for oversight and governance of MSEC had been beneficiaries of these questionable expenditures.

During our audit, we requested all of the documentation that MSEC was maintaining relative to the \$399,167 expenses it incurred on all of its credit cards during our audit period. Based on our review of the documentation we obtained from MSEC, we noted a number of problems relative to \$123,566 of these expenses. First, for \$19,801 in charges on six credit cards used by MEC managers and the MSEC/MEC Chief Financial Officer, all supporting documentation was missing. Clearly, MSEC should not be paying for any expenses incurred by MEC staff without clear, written justification and full documentation of the transactions. Further, we found that documentation was inadequate for \$103,765 in charges made on credit cards that were primarily used by MSEC's Co-Executive Directors. Moreover, based on the documentation we were able to obtain relative to these expenses, many appeared to be questionable in that they did not appear to be related to the business purposes of MSEC. For example, we identified at least \$18,284 in expenses for lunches or dinners on restaurant receipts, often labeled "Bar." Many of these meals did not appear to be required for public purposes and had notations on them indicating that the meals were for such things as farewell parties for staff. Also, we found that one of the two credit cards had been used 37 times for golf-related charges totaling \$5,735 that were sometimes labeled "staff meeting." Other charges included hotel rooms and facility charges for MSEC member school district Special Education Directors attending annual multi-day MSEC "retreats" in a Portsmouth, New Hampshire hotel during which alcohol was purchased; short-duration special education restaurant meetings; the purchase of numerous gift cards for unidentified purposes; valet parking charges; expenses associated with multi-day weekend stays at the Boston Harbor Hotel for MEC Board of Directors meetings to which MSEC managers and spouses had been invited; and costs related to travel to Florida for MEC meetings held in that state. In one instance, we found an expense totaling \$2,508 for a July 22, 2008 Lowell Spinners baseball game for use of the "Gator Pit" 100-person group food area rental that had been

improperly expensed to an MRC-funded vocational program, and a \$281 separate charge for the same game on a different credit card used by one of MSEC's Co-Executive Directors. We also noted that one Co-Executive Director's credit card was used extensively to purchase gasoline, apparently for his personal vehicle. According to MSEC's accounting records, for the three-year audit period, a total of \$4,576 in vehicle expenses (primarily gasoline) were incurred on the credit card assigned to him. Since he also received a monthly \$500 travel allowance for which travel expense documentation was not required, the additional gasoline expenses appear to constitute duplicate reimbursements. We also found instances in which certain accounting records relative to \$3,474 in credit card transactions for food establishment and internet purchases appeared to have been altered in that the credit card purchase information provided by one MSEC Co-Executive Director to the accounting department was different than the information on the credit card statement.

Some specific examples of other questionable credit card expenses we identified follow:

- A September 2009 expense of \$156 at a Market Basket in Hudson, New Hampshire for various alcohol (beer and wine) items, which was labeled on the receipt as being for a fall special education meeting.
- A December 2, 2009 expense for \$218 at the Moonstones Lounge with no explanation as to who was present or the business nature of this expense.
- A February 16, 2010 expense for \$685 at Staples for the purchase of gift cards. There is no record of who received these gift cards.
- A January 16, 2009 expense for \$209 at Fat Belly's Grill and Bar in Portsmouth, New Hampshire with no explanation as to who was present or the business nature of this expense.
- A January 15, 2009 expense for \$208 at the Muddy Rivers Smoke House in Portsmouth, New Hampshire with no explanation as to who was present or the business nature of this expense.
- Two expenses totaling \$281 at the Waverly Oaks Golf Club in Plymouth, Massachusetts on November 6, 2009 with no itemization to what was purchased.
- A January 16, 2009 expense for \$1,178 at the Portsmouth Gas Light Company (a restaurant in Portsmouth, New Hampshire) with no explanation as to who was present or the business nature of this expense.

- A July 14, 2009 expense for \$246 at the Daniel Webster Inn in Sandwich, Massachusetts with no explanation as to who was present or the business nature of this expense.

The following table summarizes all of the problems we identified during our review of MSEC credit card expenditures:

MSEC Questionable Credit Card Expenditures
July 1, 2007 through June 30, 2010

	Credit Cards Used by MSEC Managers	Credit Cards Used by MEC Managers	Total
Alcoholic Beverages	\$ 1,255	\$ -	\$ 1,255
Meals and Retreats for School District Managers and other Entertainment *	7,348	6,455	13,803
Other Non-Public Purposes *	<u>58,542</u>	<u>4,335</u>	<u>62,877</u>
Subtotal - Unreasonable Expenditures	\$ 67,145	\$10,790	\$ 77,935
Inadequate Documentation**	<u>36,620</u>	<u>9,011</u>	<u>45,631</u>
Total Questioned Credit Card Expenditures on MSEC's General Ledger	<u>\$103,765</u>	<u>\$19,801</u>	<u>\$123,566</u>

*Includes a wide range of charges such as employee meals, golf and other entertainment, clothing purchases, personal vehicle gas purchases and parking, gift cards, etc.

**Includes transactions where documentation was missing or too inadequate to determine whether the expenditure was for a public purpose.

c. Other Questionable or Inadequately Documented Non-Credit-Card Expenditures Charged to MSEC

We identified approximately \$184,650 in additional questionable (\$83,081) or inadequately documented (\$101,569) MSEC non-credit-card expenditures. Examples of such questionable expenditures include the following:

- An August 2009 expense of \$1,483 at the Nashua Country Club. This total included \$151 for food, \$359 for alcoholic beverages, and \$974 for golf fees for four people, all of which was labeled by MSEC as administrative conference and meeting expenses. The purchase order for this expenditure was authorized by the MSEC/MEC Chief Financial Officer, and the invoice had been addressed to the home of a MEC senior manager responsible for MEC professional development programming. The invoice had also been heavily redacted, with the invoice total and over half the line entries blacked out. MSEC's accounting records also include May 2008 and April 2009 entries for payments to the same country club for \$3,973 and \$3,026, respectively, that were labeled as MSEC annual board meeting expenses but for which there was no other documentation.

- A \$340 reimbursement to one of MSEC's Co-Executive Directors for an apparent personal \$200 donation he made to a Billerica School District fund raiser and the purchase of \$140 in unidentified sports equipment with no indication as to where this equipment was used at MSEC.
- An October 30, 2009 expense for \$142 to Channel Fish Processing for 30 pounds of swordfish purchased for a Special Education Director's cookout.
- Multiple December 2008 expenses totaling \$8,475, of which \$4,205 represented non-credit-card expenditures relative to MSEC's Co-Executive Directors and three other MSEC managers attending an Association of Educational Service Agencies (AESA) conference in Arizona.² All five participants were listed in conference materials as being associated with MEC rather than MSEC. The conference was a 2½ day event, but MSEC participants flew in a day early and left a day late. The early arrival day was spent playing golf, which cost \$910 for four people.
- A June 26, 2008 expense for \$313 expense to reimburse one of MSEC's Co-Executive Directors for expenses he incurred at the MEC board meeting, including \$86 for alcohol.
- A December 16, 2009 \$220 reimbursement to one of MSEC's Co-Executive Directors for his home internet expenses.

We also identified a number of expenses related to MEC activities that were inappropriately paid for by MSEC. However, the documentation maintained by MSEC relative to these expenses was often too inadequate to identify all the expenses and amounts that were incurred by MEC staff but paid for by MSEC. Examples of questionable expenses we were able to identify in this area follow:

Examples of MEC Expenses Paid for by MSEC

<u>Check Date</u>	<u>Amount</u>	<u>Payee</u>	<u>Issue</u>
09/30/09	\$7,500	Monster, Inc.	MSEC was charged for the entire annual employment service fee for "Merrimack Education Center" despite MEC's extensive use of the service for its own transportation program.
10/31/07	\$3,562	IKON Office Solutions	MSEC was charged for the entire maintenance agreement fee for office equipment at MEC's 101 Mill Road, Chelmsford site, plus \$355 for toner for equipment at 40 Linnell Circle, Billerica, which is a site shared by MSEC and MEC.
9/17/2009 through 5/20/2010	\$2,736	New Meadows Auto	Five checks for repairs to vans owned by MEC.

² The conference focused "on the cost-effective, responsive and innovative programs and services that Educational Service Agencies provide schools and other clients."

<u>Check Date</u>	<u>Amount</u>	<u>Payee</u>	<u>Issue</u>
09/30/08	\$101	Mass. RMV	Vehicle registration renewal fee for a van owned by MEC.
8/15/2008 and 11/14/2008	\$152	Chelmsford Water District	Two checks for water bills for MEC's main office.
03/31/09	\$90	Town of Topsfield	Water bill for Topsfield facility shared by MSEC and MEC charged entirely to MSEC.

d. MSEC Expenditures Charged to MEC

Generally accepted accounting principles require that expenditures be charged to the correct entities and to the functional reporting centers benefiting from the expenditure. Expenditures should be made only by properly authorized individuals, and employees should not be allowed to make expenditures on behalf of other parties without documented authorization. However, we identified \$3,715 in expenditures on credit cards assigned to the two MSEC Co-Executive Directors in which certain transactions appearing on the credit card statements had been expensed to MEC rather than to MSEC. Of this amount, \$2,068 was related to professional conferences for Massachusetts school district education administrators that were held on Cape Cod in July and November 2008 and July 2009. The expenditures covered meals and alcohol. Although the receipts were generally not itemized, one November 20, 2008 itemized receipt for \$755 at the Ocean House Restaurant in Dennis Port covered dinner and alcoholic beverages for 12 unidentified individuals. Also included was an April 7, 2009 expense at the 99 Restaurant in Billerica in the amount of \$186 for a meal event associated with the MEC Executive Director's birthday.

An additional \$10,962 in non-credit-card transactions incurred by MSEC managers had also been expensed to MEC rather than to MSEC. Over half (\$5,548) of these non-credit-card expenditures charged to MEC were reimbursements to MSEC's two Co-Executive Directors, its Chief Financial Officer (CFO), MSEC's in-house legal counsel, and three other MSEC administrative employees. These reimbursements covered the purchase of gift cards, personal cell phone and internet charges, clothing, legal work performed for MEC, and the travel of three individuals to Florida in March 2008 and 2009. Since these expenses were

incurred by MSEC employees, we question why MEC would provide reimbursement for these costs.

e. Improper Fiscal Conduit Expenditures Totaling \$1,292,180

All bills for any municipal department, including school districts, must be paid through the town or city treasurer as required by the Municipal Finance Law provisions set forth in Chapter 41, Section 35, of the General Laws. The statute states, in part:

Every town treasurer shall give bond annually for the faithful performance of his duties. . . . He shall receive and take charge of all money belonging to the town, and pay over and account for the same according to the order of the town or of its authorized officers. No other person shall pay any bill of any department; provided, however, this provision shall not prohibit the treasurer from paying such bill by the use of bank treasurer's or cashier's check. He shall have the authority given to an auditor by section fifty-one, and shall annually render a true account of all his receipts and disbursements and a report of his official acts.

Contrary to this requirement, there were at least three instances in which MSEC acted as a fiscal conduit by paying bills on behalf of member school districts. Specifically, we found that \$1,269,180 in MSEC expenses involved arrangements with the Chelmsford and Westford school districts whereby the two districts incurred expenses for providing services to students in their homes during after-school hours. Instead of paying the expenses directly, the districts processed documentation and payment through MSEC even though MSEC did not provide, coordinate, or supervise the services. MSEC then invoiced each district for reimbursement of the payments. Such arrangements, referred to as “fiscal conduits,” pose high risks for misuse, such as concealing transactions or circumventing applicable requirements and restrictions. We contacted the Chelmsford School District’s Director of Student Services, who herself characterized the activity as a fiscal conduit. She said that service providers, who are selected by student families but paid with public funds, work with the students both during the day at school and then after school at the students’ homes, with the at-home services. She confirmed that the Chelmsford public schools, rather than MSEC, provide all supervision of the service providers. When asked why the school system did not directly pay the providers for the after-school time, the Director of Student Services stated that to do so would “cause complications with their [the service providers] benefit packages.” She added that her predecessor had established the arrangements and that she had simply continued them.

We also determined that MSEC transferred \$23,000 due to the Town of Billerica for the rental of classroom space in two Billerica school buildings to a “custodial” account for expenditure at the direction of the Billerica Superintendent of Schools. Our testing of the use of these funds identified expenditures that were not approved or processed through Billerica’s Treasurer, including \$650 for the purchase of a used MEC-owned van on behalf of the Billerica Public schools; \$558 for reimbursement costs incurred by a Billerica elementary school principal at a Massachusetts Elementary School Principals Association conference on Cape Cod in May 2010; \$900 for unspecified consulting services; \$7,598 for conference expenses for the Billerica Superintendent, other Billerica educational administrators, and the Billerica School Committee chairperson; and \$17,264 that appears to have been transferred out of the fund for unidentified purposes.

In addition to noncompliance with the statutory requirements of Chapter 41, Section 35, of the General Laws to have all expenses processed through the city or town Treasurer, we also noted other problems with these transactions. First, the use of these funds did not correspond to the information in MSEC’s financial statements. Specifically, these funds were not used “in the Collaborative’s various programs and services” but were instead used for non-MSEC school district purposes and for unidentified purposes. Second, in terms of the payments MSEC made on behalf of Chelmsford and Westford school districts, it charged these districts processing fees totaling \$59,056 during our audit period. Since each of these school districts had staff who could have processed these transactions, these \$59,056 in fees represent unnecessary costs to these districts that could have been used to provide additional educational services. Finally, these transactions diminish the accountability for and transparency of school district and town finances for the districts involved.

Recommendation

MSEC needs to take the measures necessary to ensure that it maintains all records associated with its expenses such that it can be determined that these expense are reasonable and allowable. Further, MSEC should establish and implement effective internal controls over the use of credit cards by staff members. At a minimum, these controls should require staff members who use MSEC credit cards for business expenses to obtain prior authorization for these expenditures and to maintain and submit to MSEC adequate documentation relative to the business purposes

of each expense. The documentation relative to each expense should be reviewed by independent members of MSEC's administrative staff for approval prior to MSEC paying these expenses. MSEC should also immediately discontinue acting as a fiscal conduit for school districts. All existing and future transactions with school districts should be executed in writing and filed with responsible municipal officers, and all transactions should be processed through town treasurers, as required by law. Finally, given the highly questionable nature of these transactions, DESE and OSD, in conjunction with other oversight agencies such as the OAG, should conduct a review of these expenses and take whatever actions they deem appropriate to resolve this matter. This resolution should include a determination on the amount of funds that should be recovered from various MEC and MSEC officials and returned to MSEC's member communities and state contracting agencies. In the future, MSEC should ensure that it maintains documentation to substantiate the reasonableness of all of its transactions.

Auditee's Response

In response to this issue, MSEC officials provided the following comments:

MSEC states that it may be misleading to reference the outside legal costs during fiscal years 2008 and 2009 compared to the expenses for outside legal services for fiscal year 2010... The Draft Report states that for the time period covered by the OSA's audit "MSEC employed an individual to function as its full-time legal counsel." Id. The Draft Report purports to equate an increase in legal fees for fiscal year 2010 with the fact that MSEC no longer employed this individual as its full-time legal counsel. Yet, in this Section 3, the Draft Report fails to mention that the OSA also has raised questions with respect to certain legal issues concerning, among other things, past collaborative governance, internal control, procurement, contracting and tax policies during this same time period. As explained in further detail below in Section 6, for a substantial part of calendar year 2010 through the present, MSEC has utilized outside counsel to, among other things, review collaborative policies and procedures, advise with respect to compliance issues, the conflict of interest law and the Open Meeting Law, address certain employment issues, and provide general legal advice relating to special education.

Moreover, as referenced by the Draft Report, the Office of Inspector General ("OIG") conducted its investigation throughout calendar year 2010 (beginning in the second half of fiscal year 2010). At the time of the OSA's audit period, such investigation was confidential. MSEC retained counsel during fiscal year 2010 to, among other things, advise it during the investigation and to assist with its responses to several requests for information by the OIG and the production of approximately twenty-six thousand pages of documents. . . .

MSEC currently is revising its personnel policies and procedures. Issues of improving record keeping and credit card use will be addressed specifically.

During calendar year 2010, MSEC's co-executive directors reviewed and revised the policies and procedures with respect to credit card use. First, MSEC now only maintains two (2) active credit cards. One card is used by the executive assistant and the second is used by a

MSEC program director who is responsible for several small-shop and business-oriented programs. Second, prior to any use of a MSEC credit card, a detailed purchase form must be completed and submitted for review by MSEC's co-executive directors. The purchase form must include a clear, detailed purpose for the item and, when applicable, the intended educational benefit. If the purchase is approved as necessary and appropriate for collaborative use, the purchase form is signed by the program manager or director requesting the purchase or the co-executive director responsible for the program. The original purchase forms are filed and maintained within the business office.

This credit card policy is under review. As explained above, MSEC is reviewing and considering the hiring of administrators, including an internal business manager. Accordingly, MSEC's co-executive directors are recommending that if the collaborative does hire an internal business manager, then such individual should also be authorized to review, approve and co-sign a purchase form, and propose revisions to the credit card policy. There are no current plans to increase the number of credit cards used at the collaborative.

MSEC also has reduced the number of gas cards in use at the collaborative and modified its policies with respect to the use of these cards. For example, prior to the purchase of any fuel for a van or other vehicle, the responsible MSEC staff member must sign out the gas card by documenting the date and time such card was used. The MSEC staff member must also document the vehicle number fueled and must submit the original gas receipt after fuel is purchased. With respect to the Gulf gas card in particular, there is an additional procedure required whereby the MSEC staff member must also record the vehicle mileage at the time the vehicle is fueled. The Gulf gas card statements are received monthly and are reviewed and cross-checked against MSEC records.

In addition, MSEC's Board of Directors established an executive committee for the purpose of reviewing on a more regular basis the collaborative's finances. The co-executive directors are in the final stages of preparing a recommendation to the Board of Directors that such committee meet on a regular (quarterly/monthly) basis to review collaborative financial information, provide general management oversight and commentary on the collaborative's financial activity, and make recommendations relating to the presentation of such information to the Board of Directors.

Finally, as the Draft Report correctly notes, the Westford school district account is no longer in operation. Furthermore, the Billerica school district account similarly has been closed and all funds maintained in that account have been processed for return to the Billerica Public School Committee. MSEC continues to assist the Chelmsford Public Schools with a home program for students. Based on the OSA's recommendation, MSEC's management intends to have direct communications with the Chelmsford Public School Committee, including its Superintendent and Director of Special Education, regarding the account identified in the report. Chelmsford Public School officials already have expressed an interest in closing the account. MSEC's Board of Directors will take necessary steps to ensure that the collaborative is compliant with applicable laws and regulations.

Auditor's Reply

Other than the legal expenses in question, MSEC does not dispute our conclusions relative to this issue, including the almost \$3 million in questionable and undocumented credit card and other administrative expenses and the \$1,292,180 in payments for school districts that were improperly processed through the MSEC. Further, we do not agree with MSEC's assertion that

it may be misleading to reference the outside legal costs incurred by MSEC during fiscal years 2008 and 2009 compared to fiscal years 2010. The amounts presented in our report are accurate based on MSEC's financial records. In its response, MSEC asserts that the increase in outside legal costs was the result of MSEC's hiring outside counsel to, among other things, review collaborative policies and procedures, advise with respect to compliance issues the conflict of interest law and the Open Meeting Law, address certain employment issues, and provide general legal advice relating to special education. In addition, MSEC asserts that some of these legal expenses were incurred relative to the OIG's investigation of MSEC. However, since for the most part MSEC would provide us only with redacted invoices for its legal expenses, it is not possible for the OSA to comment on these assertions.

Based on its response, MSEC is taking some measures to address our concerns relative to this matter. However, we again recommend that, given the highly questionable nature of these transactions, DESE and OSD, in conjunction with other oversight agencies such as the OAG, should conduct a review of these expenses and take whatever actions they deem appropriate to resolve this matter. This resolution should include a determination on the amount of funds that should be recovered from various MEC and MSEC officials and returned to MSEC's member communities and state contracting agencies.

4. UNDOCUMENTED SALARY EXPENSES TOTALING \$6,055,816 AND QUESTIONABLE PUBLIC SERVICE TIME CREDITED TO MANY MSEC ADMINISTRATORS

Contrary to state regulations and the terms and conditions of its state contracts, MSEC did not maintain records that detail the attendance and time spent on each activity for various salaried employees who during our audit period were paid a total of \$6,055,816. Maintaining this type of information is essential for several reasons. First, because MSEC and MEC have shared employees, it is important to accurately account for these individuals' attendance and activities to ensure that the appropriate agency is charged for their salary expenses. Without such documentation, there is inadequate assurance that all of the \$6,055,816 in compensation expensed by MSEC for these staff members was proper. Second, MSEC is required by DESE program approval requirements and state contract provisions to maintain specific staff levels and ratios. Without attendance/activity records, MSEC has no way of substantiating that it met these staffing requirements. In fact, based on the financial reports that MSEC submitted to the Commonwealth, we found that MSEC did not maintain the staffing levels required by state

contracts in at least two of its state-funded programs. Further, without attendance and activity records, MSEC cannot ensure that it accurately reported the time these staff members worked in government service to the appropriate public employee retirement boards. In fact, we found that at least 10 MSEC employees may have inappropriately received credit for time worked in government service in a public employee retirement system to which they may not have been entitled.

Commonwealth Terms and Conditions for Human and Social Services have been jointly issued by the Executive Office for Administration and Finance, the Office of the State Comptroller, and the Operational Services Division/Division of Purchased Services (OSD), to which all organizations receiving human service funding such as MSEC must comply. According to these contract conditions, providers who received state human service contracts such as MSEC are required to maintain accurate and complete financial records, including payroll records, in order to receive reimbursement of these costs.

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

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

OSD has supplemented that regulatory requirement with extensive detailed guidance interpreting the regulation and its associated AICPA requirements, including sample time and activity reporting documents. That guidance appears in OSD's UFR Audit and Preparation Manual instructions for functional activity reporting center schedules required to be submitted to OSD on an annual basis. Those instructions require that, when employee activity crosses functional activity reporting centers, the employee's time and associated expense must be

tracked and documented for each functional activity center on a daily basis.³ Where required documentation is not maintained, employee personnel expense becomes questionable and nonreimbursable for state contracting purposes. According to OSD regulations 808 CMR 1.05 (26), the following expenses are non-reimbursable program costs:

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

During our audit, we found that MSEC's personnel policies and procedures only require certain hourly employees to document their time and activity using timesheets. Therefore, these policies and procedures do not meet the requirements of OSD regulations and guidance and the terms and conditions of MSEC's state contracts. For salaried employees, timesheets are only prepared in special limited circumstances to document additional time staff may work that is not required by their position, such as teachers working during the summer, during school breaks, or after regular school hours. The completion of timesheets and activity reports is essential for a variety of managerial and accountability purposes, including budgeting, pricing, and cost reporting. In MSEC's case, because MEC and MSEC have shared employees, it is especially important to accurately account for these individuals' attendance and activities to ensure that the appropriate agency is charged for their salary expenses. Further, MSEC is required by DESE program approval requirements and state contract provisions to maintain specific staffing levels and ratios. Without attendance/activity records, MSEC has no way of substantiating that it met these staffing requirements. Finally, without accurate time and attendance and activity records, MSEC cannot ensure that it accurately reported the time these staff members worked in government service to the appropriate public employee retirement boards.

Due to the internal control deficiencies noted above, during our audit we reviewed the time and attendance documentation MSEC was maintaining relative to salary expenses totaling approximately \$22 million that it incurred during fiscal years 2008 through 2010. Based on our review, we found that MSEC did not maintain timesheets or alternative detailed time and activity reporting systems for its salaried employees, for employees working across multiple activity centers or employees working for both MSEC and MEC. For many employees, such as teachers

³ The instructions also provide for the use of alternative periodic time and activity studies, which must be performed and documented in a manner meeting specific criteria established by OSD. However those alternative time study provisions are not relevant to this audit since MSEC did not conduct such studies during the audit period.

and aides working full-time within a single school or activity reporting center, this was not a significant issue, and we did not question those salary expenses. However, this lack of time and activity information was a significant problem for MSEC's administrative staff and for staff working in state-funded programs with specified staffing levels. For example, MSEC's student educational services program, referred to by MSEC as the Center for Occupational Awareness and Placement (COAP), includes components with additional supportive services (referred to as "SCOAP") and School-to-Work (STW) services. All three are subject to approval by DESE and have been approved as a single educational program with specific requirements, including provisions regarding staffing arrangements such as educator and ancillary staff to student ratios.

MSEC also operates adult vocational services, primarily purchased by DDS and MRC. Adult service activity is required to be carried out under specific provisions of state purchasing agency contracts. These contracts provide for four separate service program models, each with distinct staffing, client eligibility, approved service activity, performance, and reimbursement provisions. In order to comply with DESE's program approval requirements and maintain the staffing levels established by the state contracts that fund these programs, each program has to be operated and accounted as a discrete program in terms of revenues, expenses, and staffing in MSEC's accounting records. However, we found that MSEC was not maintaining the time and attendance information relative to these state programs in this manner. In fact, we determined through record reviews, employee interviews, and observations of program activities that these programs were in reality operated on a commingled basis, with employees, other than educational teachers, working with both students in the DESE-approved program and adult clients of the DDS and MRC/DTA state-funded programs. Further, these services were being provided without the actual staffing and other expenses associated with these programs being tracked. Instead, the salary expenses associated with the staff in these programs were arbitrarily charged to a program, with no basis such as time and attendance records or staff activity reports to support the charges. As a result of these problems, there was inadequate documentation to substantiate the reasonableness of over \$6 million in salary expenses incurred by MSEC during our audit period, as indicated in the following table:

Questionable MSEC Salary Expenses

July 1, 2007 through June 30, 2010

Activity Center	Fiscal Year 2008	Fiscal Year 2009	Fiscal Year 2010	Total
MSEC Administration	\$518,485	\$567,923	\$579,984	\$1,666,392
COAP/SCOAP/STW	871,317	1,031,833	1,077,081	2,980,231
DDS Contracted Program	208,979	219,554	398,161	826,694
MRC/DTA Contracted Programs	<u>207,785</u>	<u>198,545</u>	<u>176,169</u>	<u>582,499</u>
Total	<u>\$1,806,566</u>	<u>\$2,017,855</u>	<u>\$2,231,395</u>	<u>\$6,055,816</u>

MSEC's failure to properly document and account for employee time and activity for all staff makes it impossible for MSEC's funding school districts and the Commonwealth to be assured that all salary expenses being incurred by MSEC for these staff members are reasonable and that employee activity is in compliance with applicable program and contract requirements. In fact, as detailed in Audit Result No. 6, based on our review of the financial reports submitted by MSEC to OSD, we found several instances in which MSEC was not providing the staffing levels in its state-funded programs that it agreed to under the contracts that funded these programs.

In addition, given that MEC and MSEC share staff, MSEC's failure to maintain appropriate attendance and activity records for many of its staff members raises concerns regarding whether it correctly reported the time these staff members worked as public employees for MSEC, as opposed to MEC, to the Public Employee Retirement Administration Commission (PERAC) and the Massachusetts Teachers' Retirement System (MTRS). The pension that a retired public employee is eligible to receive is based on several factors, including the number of years of full-time creditable service they work as a public employee. In effect, the more years an individual gets credit for working as a full-time public employee, the larger his or her pension. During our review of MSEC's personnel records, we identified at least 10 of MSEC's staff who may have been given more credit for working full time for MSEC as a public employee than they were entitled to receive, as detailed below:

MEC Transportation Manager

In addition to owning the vehicles used by MSEC, MEC provides transportation services to various customers, including local school districts and human service agencies. Even though the salary of this individual, who managed MEC's transportation program, was expensed to MEC up until January 2010, during the entire audit period she was listed on the MSEC payroll, had employment contracts with MSEC, and was receiving credit as being a full-time employee of MSEC in the public employee retirement system.

Assistant to MEC's Executive Director

This person appeared as a full-time employee on MSEC's payroll and during the entire audit period received credit as a full-time employee in a public employee retirement system. However, based on her personnel file, MSEC financial records, and our own observations, this individual was working for MEC's Executive Director in MEC's main offices. This fact is further substantiated by the fact that this individual never completed any MSEC timesheets and that this individual's compensation expense was charged to MEC up until January 2010.

MSEC Director of Public Affairs and Government Issues

According to MSEC's personnel records, this individual began his employment at MSEC in 2003. He appears as a full-time employee on MSEC's payroll and received credit as a full-time employee of MSEC in the public employee retirement system until December 2008, when he left the agency. During calendar years 2007 and 2008, this person received \$209,555 in compensation as an employee of MSEC. However, our review of information on lobbyists maintained by the Secretary of State's Office indicated that, during these two calendar years, this individual was listed as a lobbyist for MEC. Also, MEC's Director of Human Resources told us that this individual worked from home for MSEC, but there were no timesheets or work products to substantiate any work performed for MSEC during the period covered by our audit.

MSEC Executive Director – MEC Deputy Executive Director

According to the contents of her personnel file, until July 2007 (fiscal year 2008) this individual had simultaneous employment contracts to function as both MSEC's Executive Director and as MEC's Deputy Executive Director. Accordingly, this individual would have had to have spent a significant portion of her time working for MEC, a non-public agency. However, according to

MSEC's payroll records, she received credit for 100% of her time in the public employee retirement system.

MSEC and MEC Chief Financial Officer

During the audit period, this individual was compensated as a full-time employee of MSEC but also received additional, incentive-based compensation from MEC and functioned as CFO for both organizations as well as the NCSD nonprofit entity. Although he would have had to spend a significant portion of his time working for MEC and NCSD, both non-public agencies, according to MSEC's payroll records he received credit for 100% of his time in the public employee retirement system prior to being transferred in January 2010 to MEC's payroll as a full-time employee of MEC.

MSEC and MEC General Counsel

During the audit period, this individual had an employment contract to function as MSEC's full-time legal counsel. However, according to information contained in the workpapers of MSEC's private accounting firms, she was actually working approximately 20% of her time for MEC. However, she received credit for 100% of her time as a public employee in the public employee retirement system.

MSEC's Two Co-Executive Directors

These individuals had employment contracts as full-time MSEC employees and during the audit period received credit as full-time MSEC employees in the public employee retirement system. However, they told us that they were also working for MEC at least through fiscal year 2009 and continued to represent MEC at certain functions subsequent to this date.

Two Administrative Assistants

These two individuals had employment contracts as full-time MSEC employees during the audit period and received credit as full-time employees in the public retirement system. However, it appeared that both actually were also simultaneously performing services for MEC. Specifically, one of the administrative assistants was identified in publicly available MEC documents as being the administrative assistant/contact person for MEC's professional development program in Billerica. The second administrative assistant worked for the individual who was MSEC's Executive Director and MEC's Deputy Executive Director until July 2007. It is therefore

reasonable to conclude that this administrative assistant was furnishing services to MEC on at least a part-time basis.

Recommendation

In order to address our concerns relative to this matter, MSEC should immediately establish policies and procedures that require all staff to document their attendance and work activities on a daily basis. MSEC should use this information to properly budget and plan its activities and ensure that contractually agreed upon program staffing levels are met, ensure that salary expenses are charged to the appropriate organizations, and ensure that staff receive their appropriate credit for government service. Finally, given the questionable nature of some of the public service time that appears to have been inappropriately credited to various MSEC employees, PERAC and MTRS should review the time credited towards the state retirement system for the individuals identified in our report and take whatever measures it deems appropriate.

Auditee's Response

In response to this issue, MSEC officials provided the following comments:

Recently, based on recommendations made by MSEC's independent accounting firm, MSEC's co-executive directors coordinated a month-long time study of five (5) identified staff members (job developers, vocational coordinator and program director) whose time was allocated to multiple funding sources (a two-week time study was stated as being sufficient). The time study was completed in March 2011, the longest month of work/school days to obtain a sample. (This time study was coordinated and conducted prior to MSEC's receipt of the Draft Report.) MSEC's co-executive directors have recommended that in the future similar time studies be used by the collaborative to assist with properly documenting the allocation of staff time across multiple budgets.

In addition to this time study, MSEC also has maintained "crew sheets" for other staff members such as job coaches (also called vocational instructors), who similarly are shared between funding sources. MSEC's job coaches provide job training and support to both students funded by the public schools as well as adults funded through the Department of Developmental Services ("DDS", formerly DMR). MSEC's staffing patterns and ratios are available by a review of the crew sheets, which are maintained on a daily basis. These crew sheets serve a safety purpose, as it allows MSEC's management to locate immediately staff members or students and adults with disabilities as the need arises. Because the crew sheet is completed daily by each job coach, and contains information that provides MSEC management with a record of where and with what staff member every MSEC student or adult with disabilities can be located on any certain day, they also provide staffing ratios. While MSEC may be able to use a sample of these "crew sheets" to show a reliable trend of appropriate staffing ratios, MSEC currently is reviewing its policies and procedures with respect to documenting job coaching staff ratios. . . .

The Draft Report also asserts that hundreds of thousands of dollars in expenses were allocated to publicly funded programs that were not properly incurred in these programs. MSEC's co-executive directors state that all of the so-called questionable salary expenses identified in the OSA report ... were paid out for actual time and direct service to the students and adults with disabilities served in these programs, so the basis for the reference to their being questionable is unknown. . . .

With respect to certain employment issues identified in the Draft Report, the 2006 ASLA stated in pertinent part that certain employees of MEC would furnish services to MSEC, and certain employees of MSEC would furnish services to MEC. The 2006 ASLA purported to identify four individuals who MSEC and MEC apparently considered to be employees of both of them. These employees include some of those identified in the Draft Report.

MSEC's current Board of Directors is not aware whether MSEC or the employees referenced within the Draft Report were ever made aware or advised of any issues or concerns with respect to the employment arrangement contemplated -- and subsequently implemented -- by the 2006 ASLA. There is nothing to suggest that counsel ever advised MSEC during this time period that there possibly could be an issue, legal or otherwise, with this employment arrangement. Similarly, MSEC's auditors, who conducted annual audits of MSEC for the fiscal years ending 2006 through 2009, also never raised any potential issues within its management letters, financial audit statements or financial performance reports with this employment arrangement. In 2009, the 2006 ASLA was terminated. MSEC's co-executive directors took steps to address and correct certain remaining payroll issues during fiscal year 2010. . . .

Based on the recommendations of its independent accounting firm, MSEC is working towards finalizing a policy to be implemented that allocates employees based on verifiable statistical analysis, such as timesheets, time studies, and other factors. MSEC conducted a time study in March 2011, which will be used to assist in future efforts to allocate employees and implement policies. MSEC also will review other procedures to ensure appropriate credit for government service.

MSEC currently is in the process of reviewing its payroll services. The 2009 ASLA deleted the provision that purported to state that "certain employees of MEC will furnish services to MSEC and certain employees of MSEC will furnish services to MEC." MSEC's Board of Directors also understand that the certain payroll issues identified within the Draft Report were corrected during calendar year 2010.

Auditor's Reply

As stated in our report, contrary to state regulations and the terms and conditions of its state contracts, MSEC did not maintain records that detailed the attendance and time spent on each activity for various salaried employees. In its response, MSEC states that "MSEC's co-executive directors state that all of the so-called questionable salary expenses identified in the OSA report were paid out for actual time and direct service to the students and adults with disabilities served in these programs, so the basis for the reference to their being questionable is unknown." Although we do not dispute that compensation was provided to these individuals, we do question whether the amounts for these expenses that were charged to these programs were

proper, since there were no records to indicate the amount of time that these individuals may have worked in these programs. The documentation improvements described in MSEC's response were not in place during the audit period. Consequently, we cannot see how MSEC can assert that the OSA's basis for questioning salary amounts for the audit period was "unknown" when it did not maintain the records necessary to substantiate which programs benefited from the expenditures or, for some expenditures, whether the employee activity actually benefited MSEC rather than MEC. In its response, MSEC states that it recently conducted a time study involving certain vocational service employees whose time was allocated to multiple funding sources. Although such time studies may be sufficient to meet OSD requirements for the future, depending on how they are conducted, they are inherently subject to potential manipulation to obtain desired outcomes. Such problems are better avoided by the proper maintenance of detailed time and activity reports as illustrated by OSD in its UFR preparation manual.

MSEC claims that it has also maintained "crew sheets" for certain staff members who are shared between vocational service funding sources. However, this fact was never mentioned to the audit staff during our audit, and no such records were provided to the OSA during the conduct of our audit field work. Although such crew sheets may currently be in use, there is no documentation that they were in use during the audit period or that, if they existed, they contained information that would have substantiated the questioned general ledger salary expense entries.

Regarding the staff retirement issues, we acknowledge that the ASLA states that certain employees would work for both MSEC and MEC. However, as stated in our report, MSEC's failure to maintain appropriate attendance and activity records for many of its staff members raises concerns regarding whether it correctly reported the time these staff members worked as public employees for MSEC, as opposed to MEC, to PERAC and the MTRS. In fact, during our review of MSEC's personnel records, we identified at least 10 MSEC staff members who may have been given more credit for working full time for MSEC as a public employee than they were entitled to receive. In its response, MSEC states that its current Board of Directors is not aware whether MSEC or the employees in question were ever made aware or advised of any issues or concerns with respect to the employment arrangements in contained in the ASLA. However, MSEC neither mentions whether its attorneys were ever asked to opine on these

arrangements nor asserts that its former board members were as unaware of the law applicable to this situation as were the current members. In any case, it is clearly the responsibility of MSEC's management to ensure that all agency transactions are conducted in accordance with all applicable laws, rules, and regulations.

5. DEFICIENCIES INVOLVING EDUCATOR PROFESSIONAL STANDARDS AND THE ABSENCE OF ORGANIZATIONAL PERFORMANCE MEASURES

We identified deficiencies in MSEC's systems for ensuring that employees are properly qualified and that DESE requirements applicable to educator licensure, evaluation, and professional development are met. During our audit period, only 30% of MSEC educators were fully licensed. The remaining educators either worked under waivers (often contrary to applicable waiver conditions) or were working without required waiver approval. Also, contrary to DESE requirements, MSEC's Board of Directors and senior managers had not established employee performance standards, had not conducted required educator evaluations, and had not ensured that new teachers are mentored by properly qualified master educators. Finally, MSEC had not established organizational performance measures needed to promote accountability and attainment of desired education and service outcomes for MSEC's students and clients.

Educator Licensure and Qualification Deficiencies

The General Laws authorize and direct DESE to establish certification requirements for teachers and other education professionals in the Commonwealth's elementary and secondary education systems. DESE regulations refer to the required certifications as "licenses." In addition, federal requirements have been established by laws such as the Individuals with Disabilities Education Act and federal regulations implementing those acts (e.g., 34 Code of Federal Regulations Parts 300 and 301). Numerous studies and reports have asserted the effect of educator qualifications on educational outcomes, and extensive discussion of federal expectations for state and local education agencies (LEA).

State oversight officials must operate within the established federal regulatory parameters, and each state's qualification systems, performance measures, and reporting systems are required to be implemented on a uniform basis applicable to all LEAs in the state. The federal definition for "local education agency" covers Massachusetts education collaboratives such as MSEC, as follows:

Local educational agency or LEA means a public board of education or other public authority legally constituted within a State for either administrative control or direction of, or to perform a service function for, public elementary or secondary schools in a city, county, township, school district, or other political subdivision of a State, or for a combination of school districts or counties as are recognized in a State as an administrative agency for its public elementary schools or secondary schools.

Contrary to such federal expectations and requirements, DESE applies special qualification and licensure arrangements for education collaboratives that are not as comprehensive as those established for the Commonwealth's local, regional, and charter school districts. For example, DESE's licensure system establishes licensure requirements for almost all functional roles for both direct teaching educators and education administrators (e.g., department directors, assistant principals, principals). However, DESE requires only certain professional education collaborative employees to be licensed, specifically those expressly covered by language appearing in, Chapter 40, Section 4E, of the General Laws, which states:

No person shall be eligible for employment by the board of directors as an instructor of children with severe special needs, teacher of children with special needs, teacher, guidance counselor or school psychologist unless the person has been granted a certificate by the board of education under section 38G of chapter 71 or section 6 of chapter 71A or an approval under the regulations promulgated by the board of education under chapter 71B or chapter 74 with respect to the type of position for which he seeks employment; provided, however, that nothing herein shall be construed to prevent a board of directors of an education collaborative from prescribing additional qualifications. A board of directors of an education collaborative may, upon its request, be exempted by the board of education for any 1 school year from the requirements of this section to employ certified or approved personnel when compliance therewith would in the opinion of the board constitute a great hardship.

DESE exempts unlisted positions such as educational administrators from licensure, instead relying on the Boards of Directors of each education collaborative to establish appropriate qualification requirements. The only exception involves education collaborative employees functioning as education administrators at DESE-approved alternative school programs, which are subject to qualification requirements established by DESE. In these programs, the requirements, codified through 603 CMR 28.09 and related documents are significantly less comprehensive than those applicable to regular school districts. They simply require that at least one staff member be designated as the educational administrator for the program and that that individual possess either a special education administrator license or, alternatively, be licensed as a special education teacher with a master's degree and at least one year's experience. That alternative standard is significantly lower than licensure requirements for regular schools and,

unlike their counterparts in regular schools (e.g., assistant principals), additional individuals in second-tier education administrative roles at alternative school programs need not be licensed.

DESE regulations also provide for the waiver of licensure requirements for individual educators when approved by DESE. That waiver process is administered primarily through an on-line password-accessed system through which the administrator or individual designated by each school district or education collaborative may request a waiver for an identified educator and certify that all applicable waiver requirements have been met, including that the individual is making satisfactory progress toward licensure as defined by DESE, that efforts are made to find licensed applicants to fill the position without the need for a waiver, and that compliance with these requirements be documented. However, during our audit, we identified a number of issues with MSEC's educator licensure and qualifications process, as follows:

Teacher Licensure and Qualification Deficiencies

We found that during our audit period, only approximately 30% of the between 54 and 59 teachers working for MSEC each year were fully licensed. As summarized in the following table, the remaining 70% of MSEC teachers appeared to be less than fully licensed for their teaching areas and were (a) teaching on waivers (often contrary to applicable waiver conditions), (b) had waiver requests disapproved by DESE but remained as teachers, (c) were teaching without the submission of waiver requests, or (d) were technically exempt from licensure and waiver requirements due to their having been hired as full-time teachers after the start of the school year. Although some teachers were hired late in the year to replace a departing teacher or a teacher going on maternity leave, in other cases positions appeared to be simply left vacant at the start of the year, with teachers not being hired until as late as November.

Teacher Licensure and Waiver Status-July 1, 2007 through June 30, 2010

	<u>FY 2008</u>	<u>FY 2009</u>	<u>FY 2010</u>	<u>Total</u>	<u>Percentage</u>
<u>Waiver Required</u>					
Approved	20	23	28	71	42.2%
Decision Still Pending as of June 1, 2010	0	0	2	2	1.2%
Not Approved	2	3	1	6	3.6%
Request Not Submitted	13	11	4	28	16.7%
<u>Waiver Not Required</u>					
Late Hire – Not Licensed	9	2	0	11	6.5%
Licensed	<u>11</u>	<u>15</u>	<u>24</u>	<u>50</u> ⁴	<u>29.8%</u>
Total	<u>55</u>	<u>54</u>	<u>59</u>	<u>168</u>	<u>100.0%</u>

In many instances, it appeared that even where waivers had been requested and approved, approval conditions had not been met. For example, one characteristic of the DESE waiver system is that waivers are routinely granted for an initial year of a staff person's employment if a school attests that it was unable to find a properly licensed educator to hire. However, DESE generally requires that in order to receive a waiver for an employee to remain in the position on a multi-year basis, the employee must demonstrate progress in completing licensure requirements such as fulfilling teacher coursework requirements and passing applicable components of licensure qualification tests. Waiver conditions require that positions continue to be advertised in an effort to obtain alternative candidates not requiring waiver approval and that documentation be retained on why the collaborative did not hire any applicants meeting licensure requirements. DESE devotes greater resources to reviewing waiver requests for a second or third year of employment and will deny waiver approval if waiver conditions are not met. We found, however, that in most cases, MSEC did not document efforts to hire appropriately qualified individuals. Waivers had sometimes been obtained for teachers for multi-year periods, after which the teachers remained in their positions without submitting waiver requests for a year or more, and then waivers were again sought and obtained as though the waivers were first-year waiver requests for newly hired teachers. First-year waivers were

⁴ For at least six of the 50 positions, MSEC documentation was not adequate to confirm that individuals were teaching within the parameters of their licenses. DESE requires waiver approval when individuals spend more than 20% of their time teaching outside of their licensed teaching area (e.g., a licensed mathematics teacher also teaching science).

obtained but neither MSEC nor the teachers took action (e.g., class enrollment) to make required progress toward licensure until the second or subsequent waiver years. Some individuals without proper licenses or teaching waivers were simply promoted into positions such as “Milieu Coordinator,” which were characterized by MSEC as administrative positions not subject to licensure or waiver requirements.

Non-Administrative Educator Position Deficiencies

DESE has not addressed licensing and qualification issues for certain types of positions. For example, in some instances individuals can meet minimum nursing qualifications established by the state’s Division of Professional Licensure, but not meet the special standards established by DESE for school nurse licensure. In fact, our audit of MSEC determined that all of the eight to 10 nurses employed each year by MSEC through the end of fiscal year 2010 were working without DESE school nurse licenses.

Additionally, DESE has not established formal qualification requirements for educators providing behavior analysis and related behavioral services to students, even though such services have long been provided by Massachusetts school districts and education collaboratives. DESE instead simply relies on school districts and education collaboratives to establish appropriate qualification requirements for educators providing behavior services to students. We noted that for one of MSEC’s Pervasive Developmental Disorder Program teachers, who was also a certified behavior analyst, a request for a DESE Severe Disabilities preliminary teacher licensure waiver had not been approved. After the waiver disapproval, MSEC simply reclassified the educator as a behavioral analyst exempt from licensure requirements, and the educator continued to work with the same student population. We also found no evidence that MSEC had established appropriate supplemental qualification requirements for these positions, such as a requirement for Behavior Analyst Certification Board (BACB) certification coupled with DESE licensure or alternative assurance of expertise in the area of autism services.

Several MSEC education programs provide primarily vocational education services but are not classified as DESE-approved Chapter 74 vocational schools. These school programs are instead approved under DESE’s alternative education regulations. For these MSEC programs, there are approximately 22 positions per year (excluding regular special education educators) at the program sites serving students with more severe functional disabilities, and a combined total of

approximately 11 positions per year at alternative schools in Topsfield and Chelmsford. At least five of the 33 positions are clearly the functional equivalent of vocational teacher positions, whereas most of the remaining positions have titles such as vocational instructor or alternative education instructor. Eight individuals filled the five vocational teacher positions over the three-year audit period. However, only two of the eight teachers were appropriately licensed (a third teacher was licensed for most of fiscal year 2008 but allowed his license to lapse in May 2008). One of the two licensed teachers, who instructed students in small engine repair, had been appropriately licensed by DESE for Automotive Technology but was released by MSEC at the end of fiscal year 2008 and replaced by an unlicensed individual. As a result, for both fiscal years 2009 and 2010 only one of the five vocational teacher positions was filled by a licensed individual (a culinary arts teacher). Moreover, no waivers were sought or obtained for any of the unlicensed teachers. These deficiencies are of particular concern due to student safety issues associated with vocational education. According to DESE, vocational educator licensure standards are designed to ensure that, in addition to being experienced and knowledgeable educators, vocational teachers possess expertise regarding safety concerns in areas such as machinery operation and the use of hazardous or toxic substances. We saw no evidence that MSEC had implemented alternative qualification arrangements to provide such assurance.

Educational Administrative Position Deficiencies

MSEC operates with approximately 14 educational administrative positions per year. Until February 2009, when one MSEC Co-Executive Director was licensed as a Special Education Administrator, none of the 14 administrators met DESE licensing regulations for their positions. Some met the regulation's alternative qualification requirements as established by 603 CMR 28.09 and related documents, whereas most obtained waivers from DESE. Each year, three to five administrative positions were filled by individuals with no DESE licenses of any kind.

Employee Evaluation, Performance, and Professional Development Deficiencies

MSEC has not complied with DESE requirements for the use of formal employee performance and evaluation systems for all educators and the use of profession development plans for certain educators. DESE regulations and guidance require education collaboratives to develop written employee performance standards accompanied by comprehensive evaluation systems. Administrators and teachers without professional teacher status are to be evaluated at least

annually, whereas those with professional status are to be evaluated at least once every two years. The importance of these requirements is stressed in DESE guidance, which states, in part:

The purpose of 603 CMR 35.00 is to ensure that every school committee^{5]} has a system to enhance the professionalism and accountability of teachers and administrators which will enable them to assist all students to perform at high levels. 603 CMR 35.00, together with the Principles of Effective Teaching and Principles of Effective Administrative Leadership adopted by the Board of Education, set out what Massachusetts teachers and administrators are expected to know and be able to do. 603 CMR 35.00 requires that school committees establish a rigorous and comprehensive evaluation process for teachers and administrators, consistent with these principles, to assure effective teaching and administrative leadership in the Commonwealth's public schools.

The 1993 Education Reform Act also provides for the use of “induction” or mentoring activities for new educators as a means of augmenting professionalism and accountability systems to improve the quality of education. These induction activities are closely related to licensure systems, since DESE regulations (603 CMR 7.00) require completion of the induction process in order to obtain professional teacher licensure status. The induction process is also closely related to supervision and performance evaluation systems, since induction activities include classroom observation and meetings with a support team whose composition must include a trained mentor and administrator qualified to evaluate teachers. In 2001, DESE published 24 pages of specific guidelines for the operation of induction activities. In addition, certain educators, including those at DESE-approved alternative education schools, are required to have approved professional development plans as a condition for maintaining licensure.

Contrary to these requirements, MSEC’s Board of Directors and senior managers have not established formal employee performance standards or evaluation systems. With the limited exception of certain speech-language professionals for whom a supervisor had conducted evaluations on her own initiative, evaluations were not performed for either new or professional teachers. Instead, the Co-Executive Directors stated that they used an informal “progressive discipline system” applicable only to problem employees. MSEC had also not ensured that professional development plans were in place for educators subject to that requirement. The only area in which MSEC had taken any systematic action involved DESE requirements for the induction and mentoring of new teachers. MSEC did maintain documentation of semi-annual group meetings and lists of teachers being mentored and their mentors. However, when we

⁵ For the purpose of the regulation, the term “school committee” is defined to include not just school committees for regular school districts but also the governing bodies of regional and agricultural school districts, education collaboratives, and charter schools.

reviewed this documentation we found that it provided no more than an assertion that mentors had been designated for some (but not all) new teachers, without actually documenting mentoring activity. Moreover, individuals assigned to act as mentors often did not meet qualifications for that role, which requires that they be trained master educators with at least three full years of experience teaching in the area being mentored after having received a license. In fact, we found that during fiscal years 2008 and 2009, at least eight of 12 mentors had not met the teaching experience standard and that five of the eight had acted as mentors when they were not even licensed.

Lack of Organizational Performance Measures

National education reform principles and systems established by DESE for school districts call for the use of education performance measures, such as MCAS and other standardized test results (by school), educator qualifications, drop-out rates, graduation rates, college enrollment figures, or the attainment of other educational or vocational goals. During our audit, we requested documentation of MSEC's organizational performance measure/outcome measure systems, whether formally adopted by its board or informally used for management purposes. The two Co-Executive Directors responded that they had no documentation to provide for the audit period, other than limited materials regarding organizational goals and objectives that had been included in information packages for the MSEC Board of Directors. As of the end of our audit, no new system had been developed or implemented. We also noted that, whereas most alternative school students at MSEC and other education collaboratives are required to take the Commonwealth's standardized MCAS tests, DESE compiles results by the school district sending the student to MSEC along with results for all other students of that district. Results are not published for each education collaborative. Since no internal or external performance measurement system is in place for MSEC, it was not possible to determine any potential educational impact of the previously described deficiencies in MSEC educator and administrator qualifications and in employee evaluation, performance, and professional development systems.

Recommendation

In order to address our concerns relative to these matters, MSEC should take measures to ensure that it fully complies with DESE and other Commonwealth staff licensure requirements and should establish a formal system of internal qualification requirements for professional and

direct service positions (e.g., educational administrators and Applied Behavior Analysis Program staff) that are not subject to mandatory state licensure requirements. Further, in cases where MSEC uses staff subject to DESE waiver provisions, all waiver conditions should be adhered to and adequately documented. MSEC should also take the measures necessary to ensure that it fully complies with the requirements of 603 CMR 35.00 relative to staff evaluations and with DESE mentoring guidelines. Finally, DESE should take whatever measures it deems appropriate to address the licensure and other regulatory compliance violations identified.

Auditee's Response

In response to this issue, MSEC officials provided the following comments:

Due to a 1985 language change in Chapter 40, Section 4E, it has not been clear whether collaboratives are subject to various Massachusetts education laws and regulations governing school districts and school committees. Over the years, the collaboratives have worked collectively to make recommendations and follow certain procedures. Accordingly, there is no uniformity among collaboratives with respect to, among other things, union employees, collective bargaining and professional teacher status. Historically, MSEC has used a progressive-discipline review and evaluation system. During calendar year 2010, however, the current MSEC Board of Directors requested that the co-executive directors prepare a more formal, collaborative-wide evaluation system. MSEC management is in the process of preparing such a system for the Board of Directors' review and consideration.

MSEC's co-executive directors contend that the collaborative maintains the required documentation to demonstrate that its hiring practices meet DESE requirements. MSEC has been audited twice in the last few years by DESE. During the first audit, MSEC provided requested documentation to DESE which satisfied its requirements. During the second audit conducted by DESE, DESE recommended that MSEC provide more detail about specific licensure requirements for the position posted in its job posting. MSEC responded timely to DESE's recommendation.

Further, during the second audit, MSEC's co-executive director sought guidance from DESE's licensure staff regarding the issue of whether MSEC was required to repost a position in an effort to replace a waived teacher with a licensed candidate if a teacher needing a waiver was hired. The co-executive director was advised by the DESE that MSEC did not need to do so. DESE advised that if the waived teacher continued to meet the progress requirements of the specific waiver, MSEC did not need to repost that position.

MSEC administrators regularly observe classroom teachers, with these observations being both announced and unannounced. Due to the frequency that administrators visit classrooms, it is not considered to be an abnormal event to cause distraction in the instruction setting thereby providing an administrator a genuine opportunity to review the interaction between teacher and student. The administrator is able to discuss with the classroom teacher classroom observations, specific student needs and general curriculum requirements. Such a setting further allows administrators to provide immediate feedback to teachers and staff. In the event serious concerns are observed, the teacher or staff member is placed on a performance improvement plan.

In addition, program managers and/or site program coordinators participate in each student's individual education plan ("IEP") meetings throughout the school year. This fosters an environment where the administrators are familiar with each student's needs, strengths and requirements. It also facilitates an environment where teachers and administrators work together to provide each student the setting necessary for the student to be successful academically, socially and vocationally.

With respect to DESE annual program approval requirements for public day programs, MSEC submits to DESE both a master staff roster as well as individual program staff rosters. MSEC's rosters include information such as the title, position within the school and license held. The roster further indicates that where a license is required, but not held, such teacher is on a waiver. MSEC's co-executive directors understand that this complies with DESE requirements for program approval. Indeed, MSEC has received full program approval by DESE every year.

MSEC employees and staff also receive training throughout the school year. Employee and staff training includes student record confidentiality, runaway policy, transportation safety, evacuation policy, coordination with sending school districts, physical restraint and bullying policies, among others. MSEC's high school programs offer MCAS preparation courses, as well as testing in the Educational Proficiency Plan process.

MSEC will review all existing job descriptions for positions that are not subject to mandatory state licensure requirements to ensure that qualification criteria are detailed and appropriate. In addition, MSEC will comply with the Board of Elementary and Secondary Education's new regulations for the evaluation of Massachusetts educators adopted on June 28, 2011. The new regulations call for full implementation of the new evaluation system by the 2013-2014 school year. MSEC will seek guidance and consultation from the DESE in order to implement this new system.

MSEC currently has a mentoring program. Although MSEC's current program does require monthly meetings between the mentor teacher and the beginning teacher and provides the time for this to occur, the program will be modified to more fully meet the outline of suggested mentoring activities provided by DESE guidelines. MSEC also will amend its current practices with regard to mentor and induction programs as outlined in DESE guidelines in order to ensure compliance with all requirements for mentor and induction programs.

Auditor's Reply

We acknowledge that Chapter 40, Section 4E, is somewhat unclear as to whether collaboratives are subject to various Massachusetts education laws, rules, and regulations governing school districts and school committees. However, there is no doubt that collaboratives are subject to DESE regulations and guidance requiring that they develop written employee performance standards accompanied by comprehensive evaluation systems. DESE has expressly confirmed the applicability of those regulations (603 CMR 35) and requirements to education collaboratives. DESE also confirmed the applicability of licensure and waiver requirements to education collaboratives, with certain exceptions, as described in our report. However, as stated

in our report, we determined that MSEC was not complying with multiple requirements applicable to educator licensure and other professional standards.

During the three-year period covered by our audit, only 29.8% of MSEC teachers were fully licensed. DESE waiver conditions require that waived teachers make satisfactory progress toward licensure, that their positions continue to be advertised in an effort to obtain alternative candidates not requiring waiver approval, and that documentation be retained on why the collaborative did not hire any applicants meeting licensure requirements. We found, however, that MSEC did not always document efforts to hire appropriately qualified individuals and therefore did not meet DESE requirements in this area. In some instances, licensure waivers had been obtained. However, in other instances waiver requests had not been approved by DESE, and in 28 instances waivers had not been requested by MSEC for teachers who required waivers. Even where waivers were obtained, MSEC often did not comply with the aforementioned waiver requirements.

During our audit, we asked MSEC officials to provide us with copies of audits/external reviews of collaborative activities and all educator licensure and waiver documentation. However, MSEC did not provide us with any DESE “audits” of licensure or waiver compliance. Consequently, we cannot comment on the extent of any audit conducted by DESE in this area or on any claimed decisions by DESE not to enforce standard waiver approval conditions. Further, the assertion that an MSEC Co-Executive Director sought guidance on waiver requirements was not brought to our attention during our audit. However, the guidance that MSEC’s Co-Executive Director stated that he obtained from DESE relative to this matter is contrary to the policy information on DESE’s website and contrary to the description of the waiver and licensing process provided to us by DESE’s Director of Licensing. MSEC did provide us with limited, incomplete documentation of communications with DESE involving a small number of waivers, and those communications generally documented DESE’s decisions not to approve the waiver requests. As noted in this report, six of MSEC’s 79 waiver requests during the audit period were not approved. Based on the limited documentation maintained by MSEC, it was not possible to determine the extent of DESE review activity for the remaining 73 requests. However, it is important to point out that, as stated above, we found at least 28 instances during our audit period in which waivers had not even been requested where required. Since MSEC never requested waivers for these 28 individuals, they would not have been

included in any waiver review conducted by DESE. In its response, MSEC asserts that “MSEC administrators regularly observe classroom teachers, with these observations being both announced and unannounced.” However, we were not provided with any documentation to substantiate that any such observations were conducted, and MSEC’s Co-Executive Directors acknowledged to us that formal staff evaluations were in fact not conducted.

Also, with respect to DESE’s annual program approval requirements for public day programs, MSEC states, “MSEC submits to DESE both a master staff roster as well as individual program staff rosters. MSEC’s rosters include information such as the title, position within the school and license held. The roster further indicates that where a license is required, but not held, such teacher is on a waiver. MSEC’s Co-Executive Directors understand that this complies with DESE requirements for program approval. Indeed, MSEC has received full program approval by DESE every year.” However, during our audit, we reviewed these rosters and found that they were not always accurate (e.g., sometimes classifying individuals as substitute teachers who were in fact regular full-time teachers for the entire school year and thus subject to licensure requirements). In addition, the rosters simply state “waiver” without documenting whether all waiver conditions have been met. It is also important to point out that the DESE staff members who approve the programs are not part of the DESE licensing unit, and their review is not designed to “audit” compliance with all licensing and waiver conditions.

MSEC’s response does not adequately address many of the other issues we identified relative to employee qualifications; evaluation systems; and professional development arrangements, such as induction mentoring, in which regular mentoring activity was not documented and eight of 12 mentors did not meet DESE qualification requirements for mentors. Although MSEC’s response describes various arrangements such as classroom observations and regular monthly mentoring activity, during our audit MSEC managers did not assert or document the existence of the activities described in MSEC’s response as currently being in place.

Based on its response, MSEC is taking some measures to address our concerns relative to this matter. In this regard, we again recommend that MSEC take measures to ensure that it fully complies with DESE and other Commonwealth staff licensure requirements and establish a formal system of internal qualification requirements for professional and direct service positions (e.g., educational administrators and Applied Behavior Analysis Program staff) that are not

subject to mandatory state licensure requirements. Further, in cases where MSEC uses staff subject to DESE waiver provisions, all waiver conditions should be adhered to and adequately documented. Finally, DESE should take whatever measures it deems appropriate to address the licensure and other regulatory compliance violations identified in our report.

6. DEFICIENCIES IN PROCUREMENT AND CONTRACT ADMINISTRATION, GOVERNANCE, INTERNAL CONTROLS, BUDGETING AND PRICING, AND FINANCIAL AND TAX REPORTING

Our audit identified deficiencies in a number of areas of MSEC's operations. First, we found numerous instances in which MSEC failed to use competitive procurement practices when procuring goods and services, contrary to state law. We also noted several questionable contract administration activities, such as MSEC's not meeting the contractually agreed-upon staffing requirements in its state-funded programs, allocating hundreds of thousands of dollars in expenses to its publicly funded programs (e.g., an estimated \$997,862 in fiscal year 2009 alone) that were not properly incurred in these programs, and requesting and receiving over \$53,000 in supplemental funding that it did not need in one state-funded program. Additionally, according to the terms and conditions of state contracts, any subcontract entered into by a contractor must be in writing and authorized in advance by the procuring state agency. Contrary to this requirement, at least \$2,839,982 in contract funding was awarded to MEC during our audit period for services that were actually provided by MSEC without documentation of the required subcontracting approval. We also identified significant governance issues. For example, on March 7, 2007 MSEC amended its Collaborative Agreement to allow the MSEC Board of Directors to amend the Collaborative Agreement without first obtaining approval from member school committees. In our opinion, such governance changes reflect a control environment that is inconsistent with the climate of integrity and transparency essential for effective and accountable government entity operations. We also found instances in which it appears that MSEC did not fully comply with the requirements of the state's open meeting law, had not established adequate internal controls over all of its activities, and was not establishing prices for its services that were consistent with guidelines established by the Massachusetts Department of Revenue's Division of Local Services (DLS) and the OAG. A detailed description of these of these issues follows:

Questionable Procurement and Contract Administration Practices

As previously noted, MSEC is required to conduct all of its procurements in accordance with Chapter 30B of the General Laws. During our audit, we first assessed the internal controls MSEC had established over its administration of contracts and, in particular, the procurement of goods and services and determined that MSEC does not have any formal written policies or procedures in this area. Based on this internal control deficiency, we then asked MSEC officials to provide us with a list of all goods and services that the agency had procured during our audit period and to provide us with the procurement and contract files. However, MSEC officials did not provide us with most of the documentation we requested. In fact, MSEC maintained almost no records containing procurement and contract information relative to any goods and services that MSEC purchased during our audit period. Therefore, it was not possible to accurately determine the number of procurements conducted or the amounts paid by MSEC for goods and services during the audit period.

In order to obtain an understanding of the agency's procurement practices, we reviewed MSEC's general accounting ledger and accounts payable files to determine whether any purchases fell under the requirements of Chapter 30B. Based on our review, we found a number of instances (in addition to the procurement issues discussed in Audit Result No. 1) in which it appears that MSEC may not have complied with the requirements of Chapter 30B. For example, with few exceptions, Chapter 30B mandates the use of a formal, public, sealed-bid process for procurements of \$25,000 or more. However, our review of MSEC's financial records revealed a number of instances in which there was no documentation to substantiate that MSEC had complied with the requirements of Chapter 30B, including payments totaling \$200,620 to a cleaning service company between fiscal years 2008 through 2010, the purchase of \$42,500 from a consultant for web development services during fiscal year 2010, and the purchase of gym equipment totaling \$29,428 during fiscal year 2010. MSEC officials stated that some of the items we questioned were procured through a state-wide procurement conducted by OSD. However, documentation required to accompany those transactions was not always present. Moreover, in cases where OSD had qualified multiple vendors, leaving the selection of specific vendors to individual purchasing entities, there was no documentation that MSEC had conducted appropriate vendor selection and price comparisons. Instead, MSEC simply selected a vendor (usually MEC) that qualified as a potential vendor.

In addition to the aforementioned contracting issues, we also identified a least two significant contract administration issues. First, the state's general contract conditions state, in part:

Any subcontract entered into by the Contractor for the purposes of fulfilling the obligations under a Contract must be in writing, authorized in advance by the Department and shall be consistent with and subject to the provisions of these Commonwealth Terms and Conditions for Human and Social Services and a Contract. When the Department furnishes federal funds to the Contractor, which are being passed down to a subcontractor, the subcontract must contain a provision that the subcontractor will comply with applicable federal single audit, cost principles and administrative requirement standards. Subcontracts will not relieve or discharge the Contractor from any duty, obligation, responsibility or liability arising under a Contract. The Department is entitled to copies of all subcontracts and shall not be bound by any provisions contained in a subcontract to which it is not a party.

Contrary to this requirement, at least \$2,839,982 in contract funding, as indicated in the following table, was awarded to MEC for services that were actually provided by MSEC without documentation of the required subcontracting approval. This funding was in addition to \$648,963 in funding from state agencies under contracts directly executed with MSEC for the three-year period covered by the audit.

Purchase of Service Funding for MSEC-Operated Programs *

July 1, 2007 through June 30, 2010

<u>Paid through MEC without Subcontract Approval</u>	<u>FY 2008</u>	<u>FY 2009</u>	<u>FY 2010</u>	<u>Total</u>
DDS Employment Services	\$691,672	\$717,267	\$752,711	
DDS Community-Based Day Services	112,693	113,906	104,419	331,018
DDS Blanket Services	33,137	20,162	-	53,299
MRC Vocational Services	59,822	74,266	-	134,088
DTA Employment Supports	69,335	75,136	-	144,471
EOHHS Salary Reserve	<u>7,237</u>	<u>8,219</u>	<u>-</u>	<u>15,456</u>
Total Paid through MEC	<u>\$973,896</u>	<u>\$1,008,956</u>	<u>\$857,130</u>	<u>\$2,839,982</u>
<u>Paid Directly to MSEC</u>				
MRC Independent Living Day Services	\$17,059	\$16,911	\$16,169	\$50,139
MRC Vocational Services	<u>160,569</u>	<u>162,725</u>	<u>275,530</u>	<u>598,824</u>
Total Paid Directly to MSEC **	<u>177,628</u>	<u>179,636</u>	<u>291,699</u>	<u>648,963</u>
Grand Total	<u>\$1,151,524</u>	<u>\$1,188,592</u>	<u>\$1,148,829</u>	<u>\$3,488,945</u>

*Source: Office of the State Comptroller accounting system records, which vary somewhat from amounts stated in MSEC financial reports.

**Of this amount, \$415,337 represented federal grant funding passed through MRC contracts with MSEC, totaling \$160,569, \$162,725, and \$92,043, respectively, for fiscal years 2008 through 2010.

Second, we found that even though the DDS employment and community-based day services and the MRC day services had been separately contracted as free-standing programs, each with its own approved budget and unit rate price, MSEC improperly operated these services as a single consolidated program referred to as the Over 22 - Today and Tomorrow Program, with shared facilities and staff. We also identified that MSEC had not adhered to the staffing and budget specifications of these contracts. Specifically, the two DDS and one MRC contract together funded 53 to 54 client slots per year for fiscal years 2008 and 2009. Although MSEC reported serving between 50 and 52 adult clients in the consolidated program each year, according to the UFRs it filed each year with OSD it did so using the equivalent of only 6.5 to 8.0 full-time equivalent (FTE) direct service employees in these programs each year as opposed to the between 14.4 and 15.4 FTE staff members that it had agreed to provide under these contracts. We estimate that this arrangement resulted in MSEC's incurring approximately \$200,000 less in salary expenses each year by understaffing these programs. In addition, MSEC then partially offset the savings it realized from not fully staffing these programs by charging administrative staff and other administrative costs to these contracts far above amounts approved by the contract budgets. For example, salary expenses associated with MSEC senior administrators were directly expensed to the program even though there was no appropriate time and activity documentation to substantiate these charges. In addition, various administrative costs, including personnel costs for MEC senior managers, were indirectly allocated to these programs in amounts exceeding those provided for in contract budgets. Specifically, although the three contract budgets had effectively authorized the expenditure of between \$25 and \$26 on administration for every \$100 spent on direct non-administrative costs, MSEC had charged the program at least \$50 per \$100 for fiscal year 2008 and at least \$49 per \$100 for fiscal year 2009 in administrative costs. Additionally, MSEC invoiced DDS for additional supplemental payments in both fiscal years 2008 and 2009, receiving a total of \$53,299 over and above its original contract amount. However, there was no evidence that MSEC actually needed this supplemental funding since there was already adequate funding provided in these contracts to fund these services. The net outcome of these questionable arrangements was a reported \$136,123 excess of revenue over expenses for the program in fiscal year 2008, a surplus equal to \$18.4% of reported program expenses. For fiscal year 2009, the excess was \$127,418 (17.6%).

Governance

During our audit, we identified several concerns relative to the governance of MSEC. First, pursuant to Chapter 40, Section 4E of the General Laws, each education collaborative is an association of school committees, with management responsibility resting with a Board of Directors composed of a designee from each member district. We obtained minutes of a non-publicly advertised meeting of the “MSEC Executive Board” held on March 7, 2007 to discuss changes to MSEC’s collaborative agreement, which had, with certain revisions in 1988, been in place since the 1976 organization of the collaborative. Superintendents from four of the seven school districts then comprising MSEC’s membership attended the meeting. The approved changes included the elimination of the provision requiring approval of administrative budgets; the addition of new member districts, including a provision prohibiting member districts from joining other education collaboratives; and a provision allowing the MSEC Board of Directors to further amend the Collaborative Agreement without first obtaining approval from member school committees. Although DESE approved this new agreement, in our opinion, the changes made to MSEC’s Collaborative Agreement at this meeting reflect a control environment that is inconsistent with the climate of integrity and transparency essential for effective and accountable government entity operations. Clearly, these changes have the effect of minimizing school committee oversight and control of MSEC. Further, this agreement remains in effect in perpetuity, having no requirement for periodic renewal by member districts or by DESE. Finally, the new provision of MSEC’s Collaborative Agreement that allows for the further amendment of the agreement without the approval of member school committees conflicts with the provision of Chapter 40, Section 4E, of the General Laws, which states in reference to the Collaborative Agreement: “The agreement shall be subject to the approval of the member school committees and the commissioner of education.”

Second, the Massachusetts Open Meeting Law, Chapter 30A, Section 11A-1/2, of the General Laws, applies to all governmental bodies, including education collaboratives. This statute requires that meetings be open to the public, that notice of such meetings be publicly posted, and that accurate records of the meeting be kept and made available to the public. Although MSEC’s Collaborative Agreement acknowledges that MSEC is required to comply with the requirements of the Open Meeting Law, during our audit we found instances in which MSEC failed to meet various requirements of this statute. Specifically, we found no evidence of

appropriate prior public posting of board meetings until November 2010. In addition, although board minutes sometimes referenced the Board of Directors entering into executive session, the documentation MSEC provided to us was insufficient to show compliance with subject material, procedural, and recordkeeping requirements applicable to such executive sessions. The law and applicable guidance promulgated by the OAG requires that executive sessions only be held for certain purposes, including labor negotiation strategy meetings, certain personnel matters, and eight other purposes specified by law, each of which is covered by detailed guidance issued by the OAG. In all cases, the basis for the executive session must be stated beforehand in a public meeting session that has been publicly posted in advance as required by law, and the decision to enter executive session must be by a roll-call vote. All discussion is to be appropriately summarized, although a written transcript is not required. All decisions and actions taken are subject to roll-call votes and must be documented and minutes for the session must be approved in a timely manner. In addition, all minutes, documents and exhibits must be retained and treated as public records. However, we noted repeated instances in which general sessions held at the start of executive sessions did not appear to have been publicly posted, and there was no documentation that executive sessions had been properly announced, approved, or conducted for permissible purposes. In at least one instance, executive session minutes were stated to have been approved over five months after the fact, in April 2008.

Third, while the MSEC Collaborative Agreement references the statutory requirement for accounting for collaborative activity through a trust fund and for the appointment of a bonded treasurer, the Superintendents comprising the MSEC Board of Directors did not establish such a trust fund and instead allowed all funds to be held on a commingled basis with MEC funds in bank accounts held in MEC's name until April 2010. In fact, for years prior to the audit period, we noted references in the notes to MEC's financial statements that MEC acted as the Treasurer for MSEC. In June 2010 MSEC appointed a part-time Treasurer. However, this individual was a former MEC manager who did not appear to have any experience in a municipal treasurer or similar position.

Finally, MSEC's Collaborative Agreement only requires its Board of Directors to meet twice a year, which is less frequent than other education collaboratives and may not be frequent enough to provide proper oversight of MSEC's activities. Further, MSEC's Collaborative Agreement

does not require proper oversight by MSEC's board because it does not require the board to review and approve any agency budgets or expenses.

Internal Controls

All organizations must establish systems for the appropriate control of operations and finances in order to minimize the risk for fraud, waste, abuse, or noncompliance with applicable legal, regulatory, and contractual requirements. Control systems also ensure adherence to internal policies, minimize the risk of undesirable events, and ensure that desired outcomes will be obtained efficiently and economically. Responsibility for establishing control systems rests with an organization's Board of Directors and senior managers.

As detailed in the other sections of this report, during our audit of MSEC we identified a number of internal control deficiencies. It is important to note that audit reports and audit management letters prepared by MSEC's three private accounting firms for periods extending at least back to fiscal year 2002 also document a long history of identified internal control deficiencies. Many of the problems identified in these reports relate to internal control deficiencies that still existed during our audit period, including the absence of appropriate written contracts with school districts and other parties, invoicing and accounting accrual deficiencies, the failure to adhere to conditions of government grants and contracts, the failure to adequately document employee time and activity, inconsistent recording of transactions, cash handling inadequacies, inadequate fraud awareness systems, and the absence of formal, written business office and accounting procedures. Even problems that were identified and addressed by MSEC staff were not addressed in a timely manner. For example, MSEC's fiscal year 2005 audit report cited the absence of formal, written procedural manuals; however, no such manuals were created until August 2008. We also identified a variety of additional deficiencies not referenced in prior year audits. These included arrangements allowing MEC to control and use an account with the Massachusetts Municipal Depository Trust even though use of such accounts is restricted by statute to government entities, and inadequate controls over revenues in its vocational school small engine repair program. In terms of the revenues in its vocational small engine repair program, although individuals are required to pay for the services they receive in this program, we found that during our audit period, \$1,662 in repair services had been provided to MEC and six managers of MEC or MSEC, including the MEC Executive Director, the joint MSEC-MEC CFO, and the current MSEC Treasurer, without documentation

of payment. The failure of an organization's Board of Directors and senior managers to establish appropriate control systems or correct identified control deficiencies typically reflects a poor control environment or "tone at the top," significantly heightening the risk for fraud, waste, or abuse on the part of senior managers.

During our audit, we also found no indication that MSEC had established appropriate control systems over information technology (IT) arrangements with MEC for shared computer systems operated by MEC. For example, there were no documented controls over MEC access to sensitive student and other collaborative electronic data, such as email and other archived electronic documents. The archiving of all electronic records, including email, is required by both federal and state recordkeeping requirements, and extensive regulatory security and privacy provisions applicable to educational entities have been established by the Federal Educational Rights and Privacy Act and by Massachusetts laws such as Chapter 93H of the General Laws, which establishes privacy and data security requirements for both public entities and private organizations and businesses. In order to ensure compliance with such requirements, MSEC should have implemented detailed policies and procedures, including standards and contractual provisions applicable to any decision to rely on an external organization such as MEC for IT operations and control and maintenance of both public records and private student and employee information. However, there was no documentation that appropriate arrangements had been established by MSEC or that such issues had been considered in purchasing IT services from MEC. Accordingly, there was insufficient assurance of statutory and regulatory privacy protection safeguards or the ability to retrieve public records and data without MEC restrictions.

In addition, we found that MSEC had not established adequate internal controls to ensure compliance with Chapter 32, Section 91, of the General Laws relative to the work a public employee can perform subsequent to their retirement. During our audit, we noted that certain retired public employees appeared to have furnished services to MSEC on an indirect basis while employed by MEC. The provision of such services is restricted by law. Specifically, Chapter 32, Section 91, of the General Laws prohibits payment for "any service rendered" by the retiree beyond 960 hours per calendar year. In addition, the compensation provided, when added to the individual's retirement allowance cannot exceed the salary that is currently being paid for the position from which the individual retired. PERAC has interpreted this language to extend

restrictions to certain situations where retirees are employed by private companies but are providing service to government entities. Despite these restrictions, we identified several individuals employed by MEC, including the MEC Executive Director and various retired school superintendents, whose provision of service to MSEC through MEC may be subject to these restrictions. We requested documentation from MSEC regarding all such service arrangements, but this information was not provided. MSEC's failure to provide requested documentation regarding these staffing arrangements made it impossible for us to determine the extent of any instances of noncompliance to the provisions of Chapter 32, Section 91.

Budgeting and Pricing

As a governmental entity, MSEC is required to establish systems to accurately budget and monitor revenues and expenses and develop detailed budget estimates so that it can establish accurate fees for services. Accurate budget estimates and comparisons of budget to actual revenue and expense information are also essential for board oversight purposes. DLS and the OAG have issued guidance relative to the fees governmental agencies such as MSEC can charge for their services. This guidance, based on Massachusetts Supreme Judicial Court decisions in cases such as *Emerson College v. Boston*, 391 Mass. 415, 427-28 (1984), effectively state that the amount of fees a governmental agency charges for services should not exceed its actual cost of providing the services. While small annual surpluses are permissible and expected due to the need to avoid incurring deficits and to allow for unavoidable expense and revenue variances due to factors such as enrollment changes, surpluses may not be unreasonably accumulated, and fees for following years should be adjusted accordingly. For local and regional school districts, these restrictions are effectively incorporated into statutes that permit generation and retention of only limited surpluses (e.g., 5%) and require that excess amounts be used as offsets for the following year. Compliance is assured through oversight review and certification by DLS, but such external control and oversight arrangements are not in place for education collaboratives. Instead, each collaborative's board is responsible for ensuring that tuition and fee-setting practices comply with legal requirements. That responsibility is carried out in conjunction with their approval and use of budget, revenue, and expense information and projections for general oversight of operations. However, we found that MSEC's budgeting, financial reporting, accounting, and pricing systems do not allow its board to affect proper oversight and ensure accountability, including compliance with applicable standards for setting fees. Further, due to

inadequate accounting and budgetary controls, MSEC has charged excessive fees to its member and non-member school districts.

We found no documentation that MSEC's Board of Directors were provided comprehensive budgets showing both projected expenses and revenue for each administrative and programmatic activity center for the year ahead, along with detailed underlying information necessary for informed review. MSEC managers provided only limited program expense information, and the board approved tuition rates based on comparisons to tuition rates at other education collaboratives or private special education schools that managers asserted were comparable to MSEC programs. The question of whether projected revenue resulting from proposed prices and available enrollment projections would meet or exceed reasonable costs for operating and administering each program was not addressed. Instead, the Board of Directors simply accepted the proposed prices, including a 15% mark-up on tuition for students from non-member school districts.

Our analysis of MSEC's fiscal year 2009 financial filings with OSD indicated that MSEC managers had in fact budgeted operating surpluses for eight of 10 tuition-based programs, with an overall budgeted surplus amount of approximately \$2.97 million (23.3%) in net revenues over a budgeted expense total of \$12.73 million for those programs. According to MSEC's own UFR filing, actual revenues for these programs were sufficient to produce a combined excess of \$2.74 million (19.8%) in net revenue over actual expenses totaling \$13.85 million. We calculated that less than \$1.07 million of the excess was attributable to the 15% mark-up on non-member tuitions, which account for approximately 55% of MSEC tuition revenue. The remaining net surplus of approximately \$1.67 million appeared to be attributable to charges to MSEC member districts that were in excess of stated operational and administrative costs. Surpluses were budgeted and generated on state-purchased programs in a similar manner, resulting in a reported budgeted overall excess revenue total of \$2.77 million (19.2%) over budgeted expenses of \$14.41 million. The actual reported results showed a total excess of \$2.62 million (16.8%) over \$15.61 million in actual expense for MSEC as reported on the fiscal year 2009 UFR. In addition, during our review of MEC's Internal Revenue Service 990 filings and the personnel file for MSEC's past Executive Director, we found evidence suggesting that MSEC managers received bonus/incentive-based compensation through MEC, which was linked to the generation of surpluses on MSEC operations.

Financial Filings with the Commonwealth's Operational Services Division

Since MSEC receives over \$100,000 in funding from state human service contracts, it is required to have annual audits performed by private accounting firms in accordance with government auditing standards and audit guidelines established by OSD. These audit reports, accompanied by financial statements and supplemental submissions, including organization and program-specific financial and employee/client information and related-party and management compensation disclosures, must be filed with OSD each year.⁶

For fiscal years 2008 through 2010, both MSEC and MEC were subject to these requirements, and neither requested nor received exemption from OSD filing requirements. Funding for those years is summarized in the following table:

Purchase of Services Funding for MSEC-Operated Programs *

July 1, 2007 through June 30, 2010

	Fiscal Year 2008	Fiscal Year 2009	Fiscal Year 2010	Total
Paid Directly to MSEC **	\$ 177,628	\$ 179,636	\$ 291,699	\$ 648,963
Paid to MSEC through MEC	<u>973,896</u>	<u>1,008,956</u>	<u>857,130</u>	<u>2,839,982</u>
Total Funding	<u>\$ 1,151,524</u>	<u>\$ 1,188,592</u>	<u>\$ 1,148,829</u>	<u>\$3,488,945</u>

*Source: Office of the State Comptroller accounting system records, which vary somewhat from amounts stated in MSEC financial reports.

**\$415,337 of this total (\$160,569, \$162,725 and \$92,043 for fiscal years 2008 through 2010, respectively, represented federal grant funding passed through MRC contracts with MSEC.

Historically, both MEC and MSEC filed a joint UFR submission with OSD due to the intertwined nature of their operations. The joint filing was made under MSEC's name, and this practice continued through fiscal year 2009. However, for fiscal year 2010, the filing included only audited financial statements and supplemental information for MSEC, without either jointly or separately filed submissions by MEC.

During our review of the UFRs filed by MSEC, we noted several financial reporting issues, in addition to the issues already discussed in this report regarding undisclosed related-party

⁶ Certain organizations, such as those with limited purchase-of-services funding and non-education collaborative government entities that file alternative financial reports with DLS, are exempt from certain UFR filing requirements. However, those exemptions do not apply to either MSEC or MEC.

transactions, non-reimbursable expenses, failure to operate programs as required by contracts, and the misreporting of staffing arrangements and associated expenses. These additional issues include the following:

- Audits of MEC and MSEC conducted for fiscal years 2008 and 2009 were not stated to have been performed in accordance with generally accepted government auditing standards, and no UFR filing whatsoever was made for MEC for fiscal year 2010, despite the fact that it was required to submit such filings.
- The MSEC and MEC management compensation disclosures were incomplete, covering some, but not all, of the individuals for whom disclosures are required by OSD. Specifically, OSD guidelines require that the name, position, and compensation, including all benefits, of all managers above the program manager level be reported in the UFR. However, the compensation and benefit amounts for the joint MSEC and MEC CFO were disclosed only for fiscal year 2009, even though he had also been on the MSEC payroll for both fiscal years 2008 and 2010. Other individuals, including certain former school superintendents employed by MEC in senior management positions, also remained undisclosed during all three years. In addition, we found discrepancies between information disclosed in the MSEC/MEC UFRs and information in MEC's IRS Form-990 filings. For example, the fiscal year 2009 UFR discloses \$421,309 in salary and \$6,600 in other compensation and benefits for the MEC Executive Director, totaling \$427,909. However MEC's IRS Form-990 filing for the same year discloses a total of \$464,411 in total compensation for this individual.
- MSEC did not properly account for its administrative expenses. Specifically, certain MSEC administrative costs, both personnel and non-personnel, were improperly reported as direct program expenses as opposed to indirect expenses as required by GAAP. Similarly, various costs associated with MEC were inappropriately allocated to MSEC program operations. As a result, we estimate that MSEC incorrectly reported approximately \$1 million in administrative costs to its own programs that should have been reported as expenses to MEC programs⁷.

Tax Issues

MSEC has not collected and deposited certain meals tax amounts as required by Chapter 64H, Section 6(cc), of the General Laws and DOR guidelines. By law, sales of meals to students are exempt from taxation. However, when meals are provided to other non-exempt individuals, including teachers and other school employees, and outside individuals such as walk-in customers or for consumption at catered business or local school district employee events, taxes must be collected and deposited with the Commonwealth. We found that although one MSEC vocational culinary arts site in Billerica deposited meals taxes for catering sales, it did not collect

⁷ Estimate is for fiscal year 2009.

or deposit meals taxes for over-the-counter sales to employees, outside visitors such as local school district and state agency officials, or walk-in customers from neighboring businesses. Further, DOR requires food service operations to maintain certain documentation regarding meals provided to both exempt and non-exempt individuals, including meal counts and sales amounts by each category. However, MSEC did not adequately maintain such records in this program and instead simply categorized catering sales as taxable and over-the-counter sales as tax-exempt, regardless of the customer's status as a student or non-student. Due to this recordkeeping deficiency, it was not possible to determine the amount of taxes that should have been collected. However, for fiscal year 2010 alone, the over-the-counter sales at this vocational program exceeded \$85,000. Moreover, during our audit we noted that the majority of sales were accounted for by non-exempt customers. Similar but smaller scale food service operations existed at both Chelmsford and Topsfield alternative vocational school sites, where meals were also sold to non-exempt individuals. For those two sites no meals tax collections or deposits had been recorded in MSEC records.

In addition, during fiscal years 2008 and 2009, we found that MSEC student wages totaling over \$1.1 million, for students who worked in its programs, had been misreported as MEC employee wages.

Recommendation

The questionable governance, internal control, budgeting, pricing, procurement, contracting, UFR filing, and tax filing issues identified in this report are being referred to responsible oversight authorities for further investigation and follow-up action, including imposition of applicable tax collections, sanctions, penalties, and the return of nonreimbursable expenses and excessive charge amounts to MSEC's member and non-member districts and the Commonwealth. In the interim, MSEC and its member school districts, as well as DESE and other oversight entities, should take immediate action to ensure that MSEC complies with all applicable laws, regulations, oversight agency guidance and contractual terms and conditions. Given the cumulative, serious, and long-term nature of the problems identified by our audit and the major conflicts of interest and other deficiencies identified regarding governance of MSEC by its Board of Directors and senior managers, we believe that immediate outside intervention, such as the appointment of a receiver, may be warranted and that appropriate resolution and recovery action may require the restructuring of MSEC and its board.

Auditee's Response

In response to this issue, MSEC officials provided the following comments:

MSEC does not under staff its programs and services. As in any organization, there may be inconsistencies that surface in the internal documentation of staffing. Here, MSEC's daily staffing patterns and ratios may not have been reflected accurately in the internal budget documents and, therefore, it may have appeared that a certain program was understaffed while another program was overstaffed. MSEC will review its internal documentation policies and procedures for accuracy and completeness.

MSEC staffing ratios are maintained at a level to maximize the number and variety of vocational experiences and training opportunities available for all adult individuals who receive services funded by the Department of Developmental Services and students who receive similar programs and services funded by sending school districts. For example, MSEC provides approximately twenty (20) work sites, compared to approximately half that amount if the sites were separated based on funding source. MSEC assigns job coaches (or vocational instructors) to specific job sites, and they may work with any combination of either COAP students or adults in the DDS services. The assignment of job coaches is based on the combined total of students or adult individuals with disabilities to ensure proper ratios. . . .

It is important to note that DDS's Quality Enhancement Survey Team (QUEST) audits DDS funded services on a regular basis to ensure program quality. These program quality audits commenced in or around 1997 and have occurred every two years since. During the OSA's audit period, DDS audited MSEC on two separate occasions (2007 and 2009). Since 1997, every QUEST audit of MSEC's DDS programs have resulted in either full 2-year certifications or 2-year certifications with distinction. . . .

Again, as with the staffing ratios, salary expenditure allocations may not have been reflected accurately in the internal budget documents, so it may appear that the allocation of expenses were inappropriately charged to one budget over another. The issue of any error in the internal budget documents was addressed prior to the Draft Report being issued and is resolved. In the future, MSEC intends to implement a policy that allocates employees based on verifiable statistical analysis and other factors.

The Draft Report also asserts that \$2.8 million was awarded to MEC and then subcontracted out to MSEC to provide the service without properly [sic] notification of the state agency. . . . MSEC believes that this is a misunderstanding, and the source of this misperception is understood. MSEC disclosed \$857,130 of funds from Department of Developmental Services (DDS/DMR) on the Supplemental Schedule A_OSI in fiscal 2010 because the program is operated by MSEC and all funds received are expended by MSEC. It was noted that contracts 3310023100310308DMR00000 and 3310023100310308DDS00000 were listed under MEC's Federal ID numbers and vendor codes. However, because these programs were operated by MSEC, MSEC took steps during fiscal year 2010 to change the contracts over to MSEC from MEC. MSEC succeeded in changing the name and Federal ID # on the contracts for fiscal year 2010 but the vendor code was not changed. The vendor code was successfully changed for fiscal year 2011.

MSEC's co-executive directors understood that two separate contracts can fund the same program, as long as the same expenses are not allocated to both contract budgets. MSEC acknowledges that accountability of employee time and other expenses to contracts is essential to ensure that the same expenses are not billed to two or more separate contracts. MSEC's private accounting firm identified and reported in its audit for fiscal year 2010 that

employee time should be allocated for employees that work among various programs based on statistical and other documented evidence. MSEC is working towards finalizing a policy to be implemented that allocates employees based on verifiable statistical analysis, such as timesheets, time studies, and other factors. . . .

In addition to the significant changes to its contractual relationship with MEC, MSEC also has taken practical steps to address several recommendations made within the Draft Report. First, by way of example, there is not a single member of the MSEC Board of Directors who also serves as a member of the MEC Board. Accordingly, there is no longer any overlap between the memberships of the two entities' Boards. Indeed, since June 2010, the composition of the Board of Directors has changed substantially. The member districts of Billerica, Chelmsford, Dracut, Tewksbury, Tyngsborough and Groton-Dunstable Regional each have designated new members to MSEC's Board of Directors. Further, in calendar year 2010, the Board of Directors elected a new chairperson who is committed to more Board involvement and management of collaborative operations. Under this new leadership, MSEC has taken significant steps to review and adopt policies and practices relating to governance, administration, internal control, budgeting and compliance issues.

For example, MSEC fully appreciates and understands the importance of being in compliance with the conflict of interest law. M.G.L. c. 268A. To that end, MSEC Board members, employees and staff regularly complete the required online training courses and provide the necessary certifications. MSEC's co-executive directors recently attended an ethics training seminar. MSEC also has distributed the Massachusetts State Ethics Commission's summary of the conflict of interest law for municipal employees, including without limitation to the present members of its Board of Directors. MSEC maintains written acknowledgements of receipt of the summary by its employees and Board members. MSEC employees complete disclosure forms relating to employment outside their respective responsibilities with the collaborative.

MSEC's current Board of Directors also have attempted in good faith to meet more regularly and in compliance with the Open Meeting Law. M.G.L. c. 30A. MSEC has sought guidance and advice from counsel on notice posting requirements, executive session procedures and proper maintenance and approval of Board meeting minutes. On occasion, MSEC also has sought guidance by the Massachusetts Office of Attorney General's Department of Open Government with respect to compliance with the Open Meeting Law. MSEC has adopted an alternative posting method whereby meeting times and agendas are published timely on its website.

MSEC is in the process of revising its policies and procedures. Issues such as record keeping and retention, internal control, budget review and technology will be addressed specifically.

Furthermore, MSEC's Board of Directors also intend to review the MSEC's Articles of Agreement. Such a review will commence in the current fiscal year. Because MSEC's Board of Directors will need to review the current Articles of Agreement in the very near future, it will consider the formal documentation of increasing the minimum amount of required Board meetings during the fiscal year. MSEC's Articles of Agreement currently require that its Board of Directors meet twice a year, but the current Board of Directors has met several times a year. In addition, as explained above, the Board of Directors recently selected an executive committee. The co-executive directors recommended that such committee meet regularly to review and discuss, among other things, collaborative financial information.

Finally, the Draft Report recommends the appointment of a receiver. . . . It offers nothing more. For example, the report offers no statutory basis for such an appointment or the process by which a receiver would be appointed. To date, MSEC's Board of Directors have

worked directly with the OSA and the DESE to obtain further information or direction with respect to this recommendation by the OSA. Should the OSA and DESE have further information, MSEC's Board of Directors welcomes the OSA's and DESE's comments. In the meantime, MSEC's Board of Directors will continue their efforts, with the cooperation and guidance of the DESE.

Auditor's Reply

MSEC does not dispute our conclusions relative to the deficiencies we identified in its procurement, contract administration, governance, and budgeting and pricing activities or its lack of adequate internal control over certain aspects of its operations. MSEC's response attributes various staffing and related expenditure variances identified by our audit to internal budgeting deficiencies by stating, "so it may appear that the allocation of expenses were inappropriately charged to one budget over another." However, as documented in our report, MSEC's own documentation for fiscal year 2009 showed that almost all of its programs had been planned to generate significant surpluses, resulting in a \$2.62 million (16.8%) excess of revenues over expenditures for that year. Had the excessive questionable expenditures documented in our other audit results not occurred, that surplus would have been even higher. In our opinion it is inconceivable that MSEC's reported financial results were simply the result of misreporting activity and expenses between programs. Further, the actual misallocation of these expenses was not only done on internal financial records but also on the financial statements that were submitted to the Commonwealth and were therefore not corrected. Contrary to what MSEC states in its response, we did not misunderstand the issue regarding the \$2.8 million in MEC contracted services that were subcontracted to MSEC. Our report correctly states the facts relative to this issue. According to the information being maintained on MMARS, the contracts in question were legally executed with MEC during our audit period through fiscal year 2010. According to guidance issued by the Office of the State Comptroller, "What appears in the MMARS system will be considered the 'official record' or 'record copy' of fiscal activities and will supersede paper or other formats of the same information."

MSEC asserts that two separate contracts can fund the same program; however this is true only when the purchasing units define the program uniformly and with the same budget, with one unit purchasing part of the program's capacity while the other contract purchases another portion of the capacity. However, this was not the situation for the contracts in question. Each contract was for a separately defined program, with a separate program code. Accordingly, MSEC is obligated to operate and report each program on a free-standing basis.

MSEC's response states that its board membership has changed significantly since the audit period; that it no longer has an overlapping board with MEC; and that it has taken various measures to improve controls and ensure compliance with conflict-of-interest and Open Meeting Law requirements. However, it is unclear whether these measures taken by MSEC will be sufficient to fully address the issues identified by our audit. For example, although ASLA payments to MEC have been at least temporarily suspended, the agreement apparently still remains in effect, and MSEC relies on MEC for extensive administrative services; all IT arrangements, including operation of its computer networks and archiving of electronic public records; program facilities and maintenance; and transportation vehicles used by MSEC programs. Resolution of many of the past issues identified by the audit may also present conflict-of-interest issues for certain MSEC managers, members of the current Board of Directors, and other managers at MSEC member school districts. Given the cumulative, serious, and long-term nature of the problems identified by our audit and the major conflicts of interest and other deficiencies identified regarding governance of MSEC by its Board of Directors and senior managers, the OSA continues to believe that immediate outside intervention, such as the appointment of a receiver, may be warranted and that appropriate resolution and recovery action may require the restructuring of MSEC and its board.

Additional Auditee Comments (Regarding Scope Impairment)

In addition to providing comments relative to the specific audit results detailed in this report, MSEC officials also provided comments regarding the scope impairment disclosure contained therein, which are excerpted below:

MSEC did not intentionally impair the OSA's audit.

a. Documentation pertaining to Merrimack Education Center, Inc. and the Northeast Consortium for Staff Development

In the Draft Report, the OSA makes plain that it is "authorized by its enabling legislation, Chapter 11, Section 12, of the General Laws, to perform audits of both governmental entities and of state contractors to 'determine compliance with the provisions of the contract or agreement, the grant, and the laws of the Commonwealth.'" . . .The OSA, however, apparently did not maintain this position consistently during the audit of MSEC. For example, by letter dated December 8, 2009, the OSA purported to notify MSEC that it intended to conduct an "audit of the Merrimack Special Education Collaborative and the Merrimack Education Center." While a copy of the December 2009 letter was forwarded to MSEC's co-executive directors, the OSA did not commence its audit work at that time. Instead, by letter dated February 4, 2010, the OSA notified MSEC that it would conduct only an audit

of "the Merrimack Special Education Collaborative." The letter continued that "as provided by 808 Code of Massachusetts Regulations (CMR) 1:04:(8), the scope of our audit will also include a review of certain records of the Collaborative's related party organization, Merrimack Education Center, Inc." (emphasis added). . . . MEC did provide documents during the audit field work. At the same time, however, the amended notice letter substantially affected MSEC's ability to obtain documents and records from MEC and provide the same to the OSA in response to its requests during the audit.

MSEC did not intentionally withhold documentation relating to MEC or NCSD. To the contrary, throughout the several months in which OSA's auditors were at MSEC facilities, the co-executive directors and other MSEC employees attempted to provide substantial cooperation, time and resources and made significant efforts to provide in a timely manner all documents and information requested from it. MSEC should not be faulted within the Draft Report for the inability to obtain certain records not in its possession.

b. Significant delay in obtaining some documentation.

The Draft Report claims that the OSA experienced significant delays in obtaining some documentation. . . . The Draft Report uses the miscommunication regarding the general ledger as an example. On or about March 31, 2010, MSEC's co-executive directors met with two OSA auditors. During this meeting, they reviewed a document that contained twenty-six (26) categories of information that the OSA sought from MSEC as part of the audit process. Category No. 19 stated:

Information on accounting and other software systems used and payroll system arrangements. If possible, we will need to have general ledger data exported for our use in a format to be determined based on the export capabilities of the accounting software used by the entities.

During the March 31 meeting, the auditor-in-charge requested that MSEC agree to provide general ledger data in an electronic format. In response, MSEC's co-executive directors advised him that MSEC was in a position to provide immediately general ledger documents and information in hard copy form. He also was advised that MSEC's co-executive directors did not know at that time what were the export capabilities of the accounting software, but that they would review the request and determine whether it was possible to provide him the requested general ledger data in an electronic format. The auditor-in-charge agreed to revisit this request at a later date. When he again requested the general ledger data in an electronic format, MSEC's co-executive directors provided it within a few short hours.

Furthermore, lest there be any doubt, MSEC maintains that there was no unreasonable delay in responding to the OSA's request for access to student records. As you know, access to student records is limited pursuant to M.G.L. c. 71, §§ 34D, 34E and 603 CMR 23:07(4). In or about November 2010, the auditor-in-charge requested access to MSEC's student records. MSEC's co-executive director responded that such records were confidential. The auditor-in-charge stated that the OSA was conducting the audit for the DESE and, therefore, he was entitled to access the records.

He further suggested that the co-executive director contact DESE directly. The co-executive director did so. The DESE legal department informed her that, to their knowledge, the OSA was not conducting the audit at DESE's request and in their

opinion the OSA was not entitled to access MSEC's student records. The co-executive director informed the auditor-in-charge that MSEC was attempting to get sufficient assurances that would allow him access to the student records. The auditor-in-charge apologized for the confusion and stated that he should have contacted DESE directly.

Shortly thereafter, it was agreed that the auditor-in-charge would be provided access to MSEC's student records. The auditor-in-charge agreed to and did provide written confirmation that (i) he was an authorized agent of the DESE for purposes of the audit; (ii) such access to student records was necessary in connection with the audit in general and related to an education program in particular; and (iii) any data collected by him and the OSA would be protected so that other third parties could not personally identify the students (and their parents) to whom the records related. MSEC made the request so that it remained compliant with applicable laws and regulations.

c. Redacted legal invoices.

The OSA requested that MSEC allow its auditors to examine documents including "correspondence and invoices from lawyers" relating to litigation, claims and assessments. MSEC's co-executive directors responded to this request by stating that they understood that under Massachusetts law communications between MSEC and its legal counsel undertaken for the purpose of obtaining legal advice or assistance are protected under the normal rules of the attorney-client privilege. In addition, the co-executive directors explained that they understood that billing records or invoices from MSEC's counsel also are protected by the attorney-client privilege because such records or invoices either revealed such attorney-client communications or the nature of the confidential services performed by its counsel. As explained at the time, the billing records and invoices also contained specific student names for which MSEC sought legal advice.

During the audit, MSEC's co-executive directors could not obtain from the OSA the necessary assurances that production of the legal invoices would not be considered a waiver of the attorney-client privilege or that information contained within the invoices would remain confidential. MSEC, therefore, provided to the OSA redacted copies of its legal bills from the identified counsel for the relevant time period which showed, among other things, the amount of time spent by counsel and the amount MSEC paid for legal services during the relevant time period, but at the same time sufficiently protected, among other things, its confidential, privileged and non-public information. Furthermore, MSEC also provided to the OSA copies of litigation files, pleadings, correspondence and several other categories of documents relating to litigation, claims and contractual agreements.

Moreover, the co-executive directors met with the OSA in an attempt to find some mutually-agreeable resolution to this issue. During this meeting, MSEC's co-executive directors expressed their continued willingness to request its counsel to provide a description and evaluation of certain matters to which counsel had provided legal consultation or representation. In response, the OSA requested that MSEC's executive directors request that counsel retained by MSEC during the audit period provide letters representing that they were engaged solely for or on behalf of MSEC and MSEC matters, and legal services were not rendered on behalf of any other organization or individual or person. To MSEC's knowledge, counsel generally provided the requested letters. MSEC, therefore, respectfully does not agree with the assertion contained in the Draft Report that MSEC's provision of redacted copies

of its legal invoices somehow impaired the OSA's ability to perform testing in this area.

d. Restricted access to certain staff.

The Draft Report claims that both MSEC and MEC restricted access to certain staff. . . . MSEC's executive directors are not aware of a single occasion in which MSEC restricted OSA's access to MSEC employees and staff. MSEC provides no comment with respect to any claimed restriction to access of MEC staff.

e. Information and records maintained by private accounting firms.

The OSA also claims that MSEC restricted information being maintained by two of the private accounting firms that conducted MSEC's annual financial audits for fiscal years 2008, 2009 and 2010. MSEC did not impose any restrictions on any records or information maintained by the two accounting firms.

The Draft Report first asserts that when the OSA "met with audit firm representatives, they informed us that attorneys for MSEC and MEC had imposed restrictions on the information to be provided to us." Draft Report, p. 10. MSEC imposed no restrictions. To the contrary, MSEC, by and through counsel, confirmed with this accounting firm's counsel that MSEC had no objection to the OSA's review of its records or information. The Draft Report further claims that for the accounting firm "which had been responsible for audits of MSEC for fiscal years 2008 and 2009, we were only provided with photocopies of the records that we requested that were heavily redacted." Id. While MSEC acknowledges that this accounting firm's records and information were redacted, MSEC neither requested that such information be redacted nor imposed any similar restriction on the information to be provided to the OSA by this accounting firm.

The Draft Report also states that "[i]n the case of the firm responsible for MSEC's fiscal year 2010 audit, we were allowed to visually inspect work papers but were not allowed to make photocopies without prior authorization from the attorneys." During the audit, MSEC understood that this accounting firm would follow their own policies and procedures with respect to providing the OSA access to its workpapers. The Draft Report is not clear whether this accounting firm was referring to its own attorneys. MSEC, however, did not impose restrictions to this accounting firm's records or information.

MSEC's co-executive directors categorically deny any assertion that MSEC was anything less than fully cooperative in this audit process, that it was unwilling to make information available for audit review, or that it intentionally impaired in any way the OSA's ability to conduct the audit. MSEC understood and appreciated its obligations with respect to the audit process, including its obligation to provide responses to reasonable requests for documents and information. To that end, MSEC provided time, resources and substantial cooperation of management, employees, staff and representatives, and made significant efforts to provide in a timely manner documents and information requested by the OSA. Indeed, for more than ten (10) months, MSEC provided several categories of documents and thousands of pages of materials in response to the OSA's numerous requests for information.

Auditor's Reply

Contrary to MSEC's assertion, the OSA consistently attempted to conduct the audit testing that it deemed necessary to assess MSEC's compliance with applicable laws, rules, and regulations and the terms and conditions of its state contracts. However, as stated in our report, in many areas MSEC impaired our ability to conduct all of our testing. Initially, given the magnitude of the related-party transactions between MSEC and MEC that were identified by the audit team while planning the audit, the OSA planned to conduct simultaneous audits of both MEC and MSEC. However, subsequently it was determined that during an audit of MSEC, the OSA would be able to review all of the information relative to the related-party transactions in question. In this regard, both of the audit engagement letters sent to MSEC clearly state that, as provided by 808 CMR 1.04(8), the scope of the OSA's audit will also include a review of records of MEC. This referenced regulation states, in part:

A Contractor shall make available for review, inspection and audit all records relating to its operations and those of its affiliates, subsidiaries and Related Parties and shall permit timely and reasonable access to its appropriate personnel for the purpose of interview and discussion related to those records and associated policies to any contracting Department, Executive Office, DPS, the Office of the State Auditor, the federal government or their representatives. Audit of records by DPS or Departments shall be conducted according to the "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions."

In accordance with this regulation, MSEC, being a state contractor, was clearly obligated to provide the requested MEC documentation. Therefore, we do not see how the OSA's second engagement letter, which clearly cites this regulation and our intent to obtain MEC records, in any way substantially affected MSEC's ability to provide this information. Moreover, given the close working relationship between the two entities and the fact that both entities essentially operated as one during most of our audit period, it is difficult to believe that MSEC officials did not have the ability to obtain all of the requested information from MEC.

Contrary to MSEC's assertion, OSA staff did experience delays in obtaining information from MSEC. In fact, as detailed throughout our report, a significant number of requested documents were never provided. In general, OSA staff made their requests for records in writing to MSEC staff. In some cases, OSA staff received most of the information it requested. In other cases, OSA staff did not receive any of the information it requested and were either provided with no explanation or with the explanation that the records were with MEC and they could not be obtained. In other instances, OSA staff received information that was incomplete and were told

that these were all the records MSEC had available. Finally, in some cases, OSA staff were only provided with photocopies of records despite the fact that MSEC staff was informed that the original records were required.

In its response, MSEC discusses the provision of an electronic version of its General Ledger as an example of how MSEC cooperated without delay in providing records to OSA staff. However, according to our records, the OSA initially asked for General Ledger information in January and then again on the March 31st date that MSEC references in its response. In response to our March 31st request, one of MSEC's Co-Executive Director's indicated that the request for an electronic version of the General Ledger was under legal review and that he would inform the audit team if an electronic version would be made available. In May, the OSA audit staff again asked MSEC's Co-Executive Director for an electronic version of the General Ledger. At this time, the Co-Executive Director asserted that MSEC's legal counsel had authorized the release of electronic version to the OSA staff on April 1, 2010. However, this fact was not conveyed to the audit team, which did not receive this record until late May. Further, when the electronic version of the General Ledger was provided, it was found to be incomplete and lacking certain transactions that were not provided to the audit staff until December 2010. Specifically, the General Ledger did not contain information relative to MRC and DTA contracts for services provided by MSEC, which totaled at least \$601,853 during fiscal years 2008 and 2009. In our opinion, the amount of time we had to wait for this information was unreasonable and clearly impaired our ability to conduct our audit testing.

In regard to student records, during the audit the OSA requested approximately one dozen student records from MSEC. The MSEC Co-Executive Director did express concerns over providing these records to the audit team. In response, the OSA staff informed the Co-Executive Director that the OSA was conducting this audit on DESE's behalf and that even if that had not been the case, federal regulations do not prohibit access by state auditors to student records needed for the purpose of auditing compliance with educational program requirements. The Co-Executive Director was told that if she had any question regarding the OSA's authority to review these records, she could contact DESE for confirmation. In the meantime, the OSA staff contacted DESE directly regarding this matter and spoke to a member of DESE's legal staff. During this conversation, a DESE attorney stated that she agreed that the OSA was authorized to access the records and that she had so informed MSEC and its attorney. The

DESE attorney also told OSA staff that she had sent MSEC's attorney a copy of a United States Department of Education letter explaining our right to review these records. Nevertheless, OSA staff were not provided with the student records we requested until 12 days after our initial request.

In terms of access to staff, it is essential that auditors are offered unimpeded access to auditee staff and the ability to conduct confidential interviews. This is because the audit staff needs to know that it can obtain complete and accurate information during our interviews. If this environment does not exist, this condition must be disclosed as a scope impairment to our audit. During our audit, when we asked MSEC staff to meet with us we were told that they had to get permission from one of MSEC's Co-Executive Directors. Moreover, on one occasion an MSEC Co-Executive Director informed OSA staff that she did not like the questions the audit staff was asking during interviews. These circumstances raised concerns over whether MSEC staff were being coached on what to say and subsequently debriefed. As a result, the audit team believed that the audit environment was such that it was not going to get complete and accurate information through interviews with MSEC staff. We therefore disclosed this condition as an impairment in our report.

As stated in our report, MSEC did not provide us with information relative to its legal bills. Regarding this issue, MSEC states that "During the audit, MSEC's Co-Executive Directors could not obtain from the OSA the necessary assurances that production of the legal invoices would not be considered a waiver of the attorney-client privilege or that information contained within the invoices would remain confidential." However, our records do not indicate that MSEC ever requested such formal assurances, and OSA staff did verbally assure MSEC that the OSA had appropriate controls in place to protect confidentiality, where needed. MSEC officials were told that without access to sufficient documentation, such as detailed invoices or work product information needed to determine whether the attorney fee charges were reasonable expenditures for MSEC, the OSA would have to treat the MSEC's refusal to provide this documentation as an impairment to our audit and to question the amounts involved.

The description of the redacted legal invoices that MSEC provides in its response is also misleading. In fact, the documents provided to the OSA staff were only sufficient to show the invoiced amounts and hourly rates, not information regarding what matters were involved,

which was information that was absolutely essential for the audit team to assess whether amounts appeared reasonable, whether potential contingent liability situations or undisclosed complaints/investigations might exist, or whether the legal services benefited entities or individuals other than MSEC. Further, aside from providing copies of MSEC responses to state agencies regarding discrimination and student abuse complaints, none of which involved the redacted invoices in question, the only attorney work product provided to the OSA staff was a copy of the most recent amendment to the ASLA.

In its response, MSEC asserts that its legal counsels generally provided the requested representation letters. However, although the law firms did provide the requested legal representation letters, the information contained in these letters was insufficient to meet our audit needs. Specifically, these letters only contained assurances on the point that legal services provided by these firms had not been provided for the benefit of other entities or individuals. However, MSEC did not provide other information that we requested MSEC to obtain from its legal counsels, such as a description of all resolved litigation claims and assessments, pending or threatened litigation, unasserted claims and assessments, contractual agreements, and an explanation for why unredacted legal invoices could not be provided. In addition, given that only redacted invoices were to be provided, we asked MSEC to obtain from its legal counsel sufficient detail regarding MSEC's legal expenses that the OSA staff could use to evaluate their reasonableness. However, this information was also not provided.

During our audit, representatives from the accounting firm that conducted MSEC's fiscal year 2010 audit told us that, although we could visually examine their audit workpapers, their client (MSEC) would not allow photocopying without prior review and approval by MSEC's attorney. Further we asked one of MSEC's Co-Executive Directors to provide the accounting firm with authorization to allow us to copy these workpapers and give us access to the workpapers of the other accounting firm that conducted MSEC's fiscal years 2008 and 2009 audits. However, to our knowledge, this request was never acted upon. If, as asserted in its response, MSEC's attorney had actually confirmed with the accounting firm that conducted fiscal MSEC's year 2010 audit that MSEC had no objection to the OSA's review of its records or information, MSEC's Co-Executive Directors should have provided us with documentation substantiating this claim.

Finally, we acknowledge that MSEC staff dedicated a significant amount of time and resources in providing the information the OSA requested during its audit. However, as stated in our report, despite being statutorily required to do so, MSEC officials did not, for whatever reason, provide us with all the information we requested and, in our opinion, did not provide us with unrestricted access to staff. Consequently, it was necessary and appropriate for the OSA to disclose these impairments in our audit report.

APPENDIX

Merrimack Special Education Collaborative Governance

MSEC Board of Directors (School District Superintendents)

School District	Fiscal Year 2008	Fiscal Year 2009	Fiscal Year 2010	As of April 8, 2011
Billerica	Anthony Serio	Anthony Serio, Chair	Anthony Serio, Chair	Richard Safier
Chelmsford	Donald Yeoman	Donald Yeoman	Donald Yeoman	Frank Tiano
Dracut	Elaine Espindle	Spencer Mullin	Spencer Mullin/Elaine Espindle **	Stacy Scott
Groton-Dunstable Regional	Alan Genovese	Alan Genovese	Alan Genovese/Joseph Mastrocola ***	Joseph Mastrocola
Nashoba Valley Technical *	Judith Klimkiewicz	Judith Klimkiewicz	Judith Klimkiewicz	Judith Klimkiewicz, Chair
North Middlesex Regional	Maureen Marshall	Maureen Marshall	Maureen Marshall	Maureen Marshall
Tewksbury	Christine McGrath	Christine McGrath	Christine McGrath	John O'Connor
Tyngsborough	David Hawkins, Chair	Darrell Lockwood	Darrell Lockwood/ Donald Ciampa ***	Donald Ciampa
Westford	Everett Olsen	Everett Olsen	Everett Olsen	Everett Olsen
Whittier Regional	Karen Sarkisian	William DeRosa	William DeRosa	William DeRosa

* *Nashoba Valley Technical High School is a regional vocational technical high school functioning as a free-standing regional district, distinct from the similarly named Nashoba Regional School District. Although a MSEC member district, Nashoba Valley Technical was not documented to have students enrolled at MSEC during the audit period.*

** *Change effective March 2010*

*** *Change effective June 2010*

Others:

James Anderson, MSEC Treasurer effective June 2010

John Fletcher, MSEC Co-Executive Director

Donna Goodell, MSEC Co-Executive Director

Carl Nystrom, MSEC/MEC Chief Financial Officer

Mary Clisbee, MSEC Executive Director - resigned July 2007

Richard W. McDonough, MSEC Director of Public Affairs and Government Issues – retired December 2008

John Barranco, MEC Executive Director responsible for general management and oversight of MSEC from October 2007 through October 2009 under the terms of amended MSEC/MEC Administrative Services and License Agreement