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INDEPENDENT STATE AUDITOR'S REPORT

ON CERTAIN ACTIVITIES OF THE

THORNDIKE STREET SCHOOL

JULY 1, 2000 THROUGH JUNE 30, 2001

**OFFICIAL AUDIT
REPORT
DECEMBER 12, 2002**

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The Thorndike Street School (TSS) was organized in 1966 as the Kirkland Nursery School, a private corporation, and in 1970 became TSS, a private nonprofit corporation. During our audit period, TSS provided daycare services to eligible consumers in Cambridge, Massachusetts.

Prior to our audit, the state's Office of Child Care Services (OCCS), one of the agencies that provide funding to TSS, received complaints from a TSS employee alleging the misuse of state funds by TSS. Consequently, on August 20, 2001, OCCS conducted an onsite review of TSS's programmatic and financial information for fiscal years 2000 and 2001. As a result, OCCS determined that TSS lacked internal controls, misused Commonwealth funds, and served children of families that do not meet OCCS income-eligibility requirements. Subsequently, OCCS, through the state's Operational Services Division, requested that the Office of the State Auditor review this matter.

Our audit, which covered the period July 1, 2000 through June 30, 2001, had the following objectives: (1) to assess TSS's management control systems to determine whether management's recording, reporting, and monitoring of financial activity was adequate to ensure that resources are adequately safeguarded and used economically and efficiently; (2) to determine TSS's compliance with applicable laws, rules, and regulations, including processes for planning, organizing, directing, and controlling program operations; and (3) to conduct audit testing to determine whether TSS had implemented any new controls since OCCS's review.

Our audit found that TSS did not have adequate internal controls over many aspects of its operations and had improperly charged the Commonwealth as much as \$146,549 for program services.

AUDIT RESULTS

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1. INADEQUATE DOCUMENTATION REGARDING UP TO \$146,549 IN PROGRAM EXPENSES

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We found that contrary to OCCS guidelines, TSS did not maintain adequate documentation to substantiate that the daycare services for which it billed OCCS during the audit period were provided to clients eligible to receive those services. We also found that contrary to state regulations, TSS did not maintain adequate documentation to substantiate all of the administrative expenses that it charged against its OCCS contracts during the audit period. As a result, the Commonwealth cannot be assured that the \$146,549 that TSS billed to and received from OCCS during the audit period was appropriately charged.

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We found that TSS had not developed and implemented adequate internal controls over all aspects of its operations. Specifically, TSS did not have written internal control policies and procedures to reasonably ensure the accuracy of its financial transactions and reporting of its financial data; did not maintain records in accordance with state regulations; did not adequately segregate responsibilities in its accounting department; and did not maintain an active Board of Directors to oversee its operations. As a result, TSS and the Commonwealth cannot be assured that TSS assets and Commonwealth funds were properly safeguarded from loss, theft, or misuse, and that OCCS contract-related transactions were properly authorized, recorded, processed, and reported.

INTRODUCTION

Background

The Thorndike Street School (TSS) of Cambridge, Massachusetts, was originally organized in 1966 as the Kirkland Nursery School, and in 1970 became TSS, a private nonprofit corporation.

During the audit period (July 1, 2000 through June 30, 2001), TSS was licensed by the Commonwealth to provide daycare services to as many as 33 children. The agency was providing services to 17 children under a contract with the Office of Child Care Services (OCCS) and to 16 children whose daycare slots were funded by the state's Department of Education (DOE).

TSS receives funding from various sources, as indicated in the following table:

**Thorndike Street School
Summary of Revenue Sources
July 1, 2000 through June 30, 2001**

Revenue Source	Revenue
Office of Child Care Services	\$146,549
Department of Education	36,170
Child Care Resource Center	12,788
Cambridge Community Partnership	63,730
Tuition	16,084
Interest	109
Other	<u>10,325</u>
Total	<u>\$285,755</u>

Note: TSS was not maintaining accurate and complete financial records as required by state regulations (see Audit Result No. 1). Consequently, the revenue amounts indicated are estimates made by the audit team based on available agency data and may not include all revenue.

During fiscal year 2001, OCCS received complaints from a TSS employee alleging the misuse of state funds by TSS. On August 20, 2001, OCCS staff conducted a review of TSS's internal control procedures, various expenditures, and utilization of income-eligible childcare slots for

fiscal years 2000 and 2001. The OCCS review found that TSS was operating without internal controls, misusing Commonwealth funds, and serving children of families that do not meet OCCS's income-eligibility requirements. Consequently, OCCS determined that TSS was in breach of its contract with OCCS and recommended that TSS develop better internal controls and client records. Subsequently, TSS did not demonstrate to OCCS that it had taken measures to address OCCS's concerns, and on November 27, 2001, OCCS terminated its contract with TSS.

OCCS, through the state's Operational Services Division (OSD), the agency responsible for regulating the activities of contracted human-services providers (such as TSS), contacted the Office of the State Auditor (OSA) and requested that the OSA audit TSS. Subsequently, the OSA initiated an audit of the agency.

Audit Scope, Objectives, and Methodology

The scope of our audit included various financial and operational activities of TSS for the period July 1, 2000 through June 30, 2001. Our audit was conducted in accordance with applicable generally accepted government auditing standards for performance audits and included audit procedures and tests that we considered necessary. Our specific objectives were to

- Assess TSS's management control systems to determine whether management's recording, reporting, and monitoring of financial activity were adequate to ensure that resources are adequately safeguarded and being used economically and efficiently
- Determine TSS's compliance with applicable laws, rules, and regulations, including processes for planning, organizing, directing, and controlling program operations
- Conduct audit testing to determine whether TSS had implemented new controls since OCCS's review

To achieve our objectives, we assessed the system of management controls that TSS had established and implemented regarding its operations. The purpose of our assessment was to obtain an understanding of management's attitude, the control environment, and the flow of transactions through TSS's accounting system. This assessment was used in planning and performing our audit tests. We reviewed TSS's administrative documents, including internal

policies and procedures. We then reviewed applicable laws and regulations and examined billings, invoices, and other pertinent financial records to determine whether expenses incurred under TSS's contracts with OCCS were reasonable, allowable, allocable, properly authorized and recorded, and in compliance with applicable laws, rules, and regulations. Finally, we met with key OCCS officials to obtain and evaluate the results of their review. Our review was not intended to form an opinion on TSS's financial statements. We also did not assess the overall quality and appropriateness of program services being provided by TSS.

Hindrances Encountered

During our audit, the Director of TSS engaged in activities that limited the ability of the OSA to perform audit testing. Consequently, the timeliness of the audit work was affected and the OSA was obstructed from applying the audit procedures it considered necessary.

The OSA is authorized by its enabling legislation, Chapter 11, Section 12, of the Massachusetts General Laws, to perform audits of entities such as TSS that receive funding from the Commonwealth. Those audits are intended to determine compliance with the provisions and requirements of contracts or agreements with the Commonwealth and the laws of the Commonwealth. Specifically, Chapter 11, Section 12, of the General Laws states, in part:

The state auditor shall have access to such records at reasonable times and said department may require the production of books, documents, vouchers, reports, and other records relating to any matter within the scope of such audit.

Additionally, regulations promulgated by the OSD, the agency responsible for regulating the activities of service providers such as TSS, require service providers to provide all records that the OSA and other organizations need to complete an audit. Specifically, 808 Code of Massachusetts Regulations (CMR) 1.04(8), effective February 8, 2000, 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, regarding how contracted service providers are required to maintain their financial records, 808 CMR 1.04, states, in part;

The Contractor and its Subcontractors shall keep on file all data necessary to satisfy applicable reporting requirements of the Commonwealth...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 (GAAP) 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.

Despite these statutory requirements, during the conduct of our audit fieldwork TSS did not make all of its records available to the audit staff within reasonable times and was not maintaining its records in accordance with state regulations.

Because TSS was not maintaining accurate and complete financial records in accordance with GAAP, it could not provide various records, including a general accounting ledger detailing all financial transactions, or any audited financial statements, for the audit period. Additionally, in many instances, the records provided by TSS were incomplete. (See Audit Result No. 1.)

As a result, our ability to perform sufficient audit testing was impaired, and the audit results and opinions expressed in this report are based solely on the limited documentation that TSS provided to the audit team.

Subsequent to the completion of our audit fieldwork, copies of our draft audit report were mailed to both TSS's business address and to a post office box address used by TSS, for the agency's review and comments. TSS did not provide us with a written response to our draft report. However, the matters in this report were discussed with TSS officials during the conduct of our audit fieldwork, and the officials' comments relative to these matters were considered in the drafting of our final report.

AUDIT RESULTS

1. INADEQUATE DOCUMENTATION REGARDING AS MUCH AS \$146,549 IN PROGRAM EXPENSES

We found that contrary to Office of Child Care Services (OCCS) guidelines, the Thorndike Street School (TSS) did not maintain adequate documentation to substantiate that the daycare services for which it billed OCCS during the audit period were provided to clients eligible to receive those services. We also found that contrary to state regulations, TSS did not maintain adequate documentation to substantiate all of the administrative expenses that it charged against its OCCS contracts during the audit period. As a result, the Commonwealth cannot be assured that all of the \$146,549 that TSS billed to and received from OCCS during the audit period was appropriately charged.

OCCS has promulgated eligibility and fee assessment guidelines with which all childcare providers that contract with OCCS must comply. Regarding the maintenance of documentation, OCCS guidelines state, in part:

All documentation upon which the provider or Child Care Resource & Referral Agency [CCR&R] relies when determining eligibility must be maintained in the family's file.

Parents receiving TAFDC [Temporary Aid for Families with Dependent Children] benefits will receive a Child Care Authorization from the Department of Transitional Assistance. The Child Care Authorization will serve as sufficient documentation of the required income, service need, residence, relationships and social security information until the parent begins earning income....

Documentation of income, service need, residence and relationship for non-TAFDC parents must be maintained in the family's file.

Regarding residency, OCCS guidelines state the following:

Documentation of the family's residence must be maintained in the family's record. Acceptable documentation for verifying a residence includes copies of bills (gas, electric, telephone, cable or other type of bill with current address) dated within 45 days of the applications; or a copy of a rental documentation.

Regarding relationship and family size, OCCS guidelines state, in part:

Evidence of the relationship of all children in the family under 18, or age 24 if the children are full time students, must be maintained in the family's record.... The

preferred evidence of relationship is a birth certificate showing the names of the parents and the child.

Regarding the termination of services, OCCS guidelines state, in part:

Parents may be terminated from publicly subsidized child care services for several reasons, including:

- *lack of continuing service need*
- *failure to submit required documentation....*

Failure to submit the documentation required to establish the continuing service need and income eligibility may result in the termination of care.

During our audit we reviewed the files of all 30 families that received services from TSS through contracts with OCCS during fiscal year 2001. Our audit found that of the 30 files examined, 18 (60%) did not contain any documentation of proof of Massachusetts residency and 21 of the 30 files (70%) were missing evidence of family-size verification. TSS's Director stated that she had requested the required birth certificates and residency documentation, but parents in some cases had not complied.

Families participating in OCCS-funded programs must pay fees in accordance with the Commonwealth of Massachusetts Sliding Fee Scale for Child Care. OCCS policy statement P-OCCS-Subsidy 00-2, titled "Fees," states, in part:

Most families who are eligible for subsidized child care will be required to contribute to the cost of the child care services they receive. The amount a family contributes depends on the family's income and size, and the type of care received.... To determine the appropriate fee, consult the Commonwealth of Massachusetts Sliding Fee Scale for Child Care.

We found that despite this policy, in 13 (43%) of the files in our sample TSS did not use the applicable sliding fee scale, resulting in families being assessed incorrect fees. Of the 13 families, 10 were under-assessed (a total of \$5,182), and three families were over-assessed (a total of \$1,077), resulting in the Commonwealth paying \$4,105 (\$5,182, less \$1,077) more than necessary.

OCCS guidelines also require providers such as TSS to review, at least once every six months, the income of families that receive services and to complete a new Child Care Application and Fee Agreement. If the income changes, the provider must verify the accuracy of the changes and, if necessary, reassess the fee. Regarding this issue, OCCS guidelines state, in part:

Each family must have its income and service need eligibility and fee determination reviewed at least every six months, or sooner if the parent reports or the provider or CCR&R becomes aware of a change in family size, income, or service need.

A new Child Care Application and Fee Agreement must be completed at least every six months.

We found that TSS did not conduct semiannual reassessments of family income for 16 of its 30 clients (53%) during fiscal year 2001. Moreover, TSS staff used the original agreement form, noting new information in the margins or next to the original data rather than using new forms. That practice makes it extremely difficult to differentiate new information from old.

Regarding these matters, TSS's Director admitted that she was not diligent in obtaining all of the documentation required by OCCS. The Director explained that TSS serves a wide range of clients with diverse backgrounds, often making communication difficult. She added that many of the parents receiving services had limited reading, writing, and verbal skills that inhibit them from properly completing applications and providing the required documentation. Clearly, TSS is nevertheless responsible for obtaining the required documentation. By not doing so, it cannot be assured that clients are eligible to receive services and are paying appropriate fees.

In addition to reviewing client files, we reviewed certain administrative expenses that TSS billed against its state contracts during the audit period.

The 808 Code of Massachusetts Regulations (CMR) 1.05 (26) and (12), promulgated by OSD, identify the following as nonreimbursable costs under state contracts:

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

Non-Program Expenses: Expenses of the Contractor which are not directly related to the social service program purposes of the contractor.

During our audit, we reviewed a judgmental sample of 35 administrative expenses, such as \$560 for holiday gifts, \$1,461 in conference expenses, and \$4,340 for student interns, that TSS charged against its OCCS contracts during the audit period (July 2000 through June 2001). Those 35 expenses, which totaled \$21,164, accounted for 33% of the total checks written and 7% of the total administrative costs incurred and charged to the state by TSS during this period. Our review determined that TSS did not have adequate supporting documentation for the 35 expenses. Specifically, there were no purchase orders, invoices, contracts, or accounts-payable files regarding these expenses. Consequently, TSS could not demonstrate that they were actually incurred, necessary, or program-related.

Regarding these matters, TSS's Director stated that she believed that all of the expenses incurred during the audit period were program-related. She explained that her vehicle had recently been broken into and that many of TSS's financial records were stolen. We requested a copy of the police report that the Director had filed regarding the theft, but we were not provided a copy. The Director also told us that the agency's accounting firm had some records, but the Director was unable to retrieve those records.

TSS's Director informed us that as a result of our audit and OCCS's review, she hired a part-time bookkeeper and an accounting firm to assist with the implementation of adequate administrative and accounting policies and procedures.

Recommendation

OCCS should use the results of its own review and our audit to determine which portion of the \$146,549 it paid to TSS during the audit period is unallowable and should therefore be recovered from the agency. In the future, TSS should take measures to implement adequate controls over all aspects of its operations, and if TSS continues to contract with

Commonwealth agencies, it should take measures to ensure compliance with all applicable laws, regulations, and contracted terms and conditions.

2. INADEQUATE INTERNAL CONTROLS OVER VARIOUS ASPECTS OF AGENCY OPERATIONS

We found that TSS had not developed and implemented adequate internal controls over all aspects of its operations. Specifically, TSS did not have written internal control policies and procedures to reasonably assure the accuracy of its financial transactions and reporting of its financial data; did not maintain or retain records in accordance with state regulations; did not adequately segregate responsibilities in its accounting department; and did not maintain an active Board of Directors to oversee its operations. As a result, TSS and the Commonwealth cannot be assured that TSS assets and Commonwealth funds were properly safeguarded from loss, theft, or misuse and that OCCS contract-related transactions were properly authorized, recorded, processed, and reported.

Establishing and maintaining an effective internal control structure is the responsibility of management. Internal controls are essential to maintaining full accountability for resources and effectively and efficiently achieving management objectives. However, during our audit we found that TSS had not developed and implemented effective internal controls over several aspects of its operations.

a. Written Policies and Procedures

According to GAAP, entities such as TSS are required to establish an adequate system of internal controls (i.e., written policies and procedures) over all aspects of their operations. However, we found that TSS had not developed and implemented written policies and procedures over its operations. Without adequate internal control policies and procedures, there is an increased risk that agency transactions may not be properly recorded, authorized, processed, and summarized, and the reporting of financial data may not be consistent with financial-statement disclosures. Moreover, the absence of relevant internal control policies and procedures results in inadequate assurance that Commonwealth funds are being properly safeguarded against loss, theft, or misuse. Regarding this matter, TSS's Director stated that

there were no written policies and procedures at TSS because its primary goal was to ensure that each child TSS cared for received the proper transportation, nutrition, supervision, and education throughout the day, and that she chose to concentrate her efforts in those areas rather than perform certain administrative tasks.

b. Recordkeeping and Retention and Inspection of Records

Our audit also identified that contrary to the terms and conditions of TSS's contract with OCCS, TSS is not maintaining its records for the required seven-year period.

The state's Executive Office for Administration and Finance (EOAF) and OSD have promulgated the Commonwealth Terms and Conditions for Human and Social Services (General Contract Conditions), with which all human service providers that receive state funds must comply. Regarding the maintenance of records, the General Contract Conditions state, in part:

The Contractor shall maintain records, books, files and other data as required by 808 CMR 1.00 and as specified in a Contract and in such detail as shall properly substantiate claims for payment under a Contract, for a minimum retention period of seven (7) years beginning on the first day after the final payment under a Contract, or such longer period as is necessary for the resolution of any litigation, claim, negotiation, audit or other inquiry involving a Contract...

Moreover, 808 CMR 1.04 (1) regarding recordkeeping and reporting requirements states, in part:

The Contractor shall keep on file all data necessary to satisfy applicable reporting requirements of the Commonwealth...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... Books and records shall be maintained in accordance with generally accepted accounting principles as set forth by the American Institute of Certified Public Accountants.

During our audit we found that contrary to its contract with OCCS and OSD regulations, TSS did not maintain or retain its financial records, books, and other data in sufficient detail to substantiate revenues associated with and claims for payments for services rendered under its contract with OCCS for the period required by the General Contract Conditions. As noted in Audit Result No. 1, many financial records for the two most recent fiscal years were

unavailable. Moreover, TSS lacked a comprehensive accounting system that would provide for the preparation of complete, accurate, and auditable financial statements in accordance with GAAP. As a result of inadequate financial records, TSS could not demonstrate that transactions and events associated with its OCCS contract were properly recorded, processed, authorized, summarized, reported, and represented valid program expenses.

c. Lack of a Board of Directors to Oversee Agency Operations

Our review noted that TSS did not have an active Board of Directors to oversee its operations, contrary to state law. As a result, there were inadequate controls in place to ensure that TSS's activities were being effectively and efficiently conducted and were in compliance with applicable laws, regulations, and contractual terms and conditions.

Chapter 156B, Section 47, of the Massachusetts General Laws states, in part:

The business of every corporation shall be managed by a board of directors. The Board of Directors of a public service agency is the primary organizational body that ensures the agency meets its operational objectives in the most effective and efficient manner. Board members perform a variety of key functions, including overseeing the overall operation of the agency, setting policies and procedures to ensure that agency objectives are met, and hiring the agency's top executive.

The Commonwealth Terms and Conditions for Human and Social Services, which all Human Service Providers must sign, states in Section 11: "The Contractor shall comply with the principles in the Massachusetts Attorney General's 'Guide for Board Members of Charitable Organizations,' and with the standards for boards contained in the American Institute of Certified Public Accountants (AICPA)'s statements on auditing standards...." That guide identifies the following financial responsibilities of charitable organizations' board members:

As a board member you have primary responsibility for making sure that the charity is financially accountable, has mechanisms in place to keep it fiscally sound, operates in a fiscally sound manner, and is properly using any restricted funds it may have. The board shall be involved in all aspects of the finances of the charity....

The budget should be developed early enough so that the entire board can be involved in its review and approval before the beginning of the fiscal year.

The board should be sure that the charity has adequate internal accounting systems.

Board members should expect management to produce timely and accurate income and expense statements, balance sheets and budget status reports and should expect to receive these in advance of board meetings.

The board should require periodic confirmation from management that all required filings (such as tax returns and the Massachusetts Form PC) are up-to-date and that employee withholding taxes and insurance premiums are being paid when due.

To determine the extent of the TSS Board of Directors' involvement and oversight of TSS operations and compliance with the above-mentioned provisions, we requested that the TSS Director provide us with the Board of Directors' meeting minutes for fiscal year 2001, the period of our audit. However, TSS's Director could not provide documentation to substantiate any board involvement or oversight for the audit period. The Director stated that Board of Directors' meeting minutes were not recorded. Furthermore, she claimed that informal board meetings were held frequently, but not at specific intervals, and that formal board meetings were held quarterly. However, when we requested the minutes for the formal quarterly board meetings, the Director was unable to provide them.

Due to the lack of documentation regarding board involvement and oversight, an appraisal of the board's conduct could not be made. Moreover, TSS could not assure the Commonwealth that it has an active board in place to ensure that agency objectives are efficiently and effectively met, consistent with applicable requirements. Several questionable activities of TSS's management could have been prevented if TSS had had an active Board of Directors overseeing its operations.

d. Lack of Segregation of Duties

An effective internal control structure ensures the adequate segregation of the duties and responsibilities of individuals involved in the custody of assets, the authorization and recording of transactions, and the reconciliation of records. However, during our audit we learned that TSS's Director was responsible for several related activities, including the procurement of all goods and services and complete control of the school's ATM debit card and petty-cash funds. The Director also processed all bills for payment—opening the mail, writing and signing all checks, and maintaining all vendor and paid bill files. The Director

also had full control of all payroll functions, including calling in hours to the payroll service provider and distributing paychecks.

Regarding the segregation of duties, Section 7 (Recordkeeping and Retention, Inspection of Records) of the General Contract Conditions promulgated by EOAF states, in part:

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

Regarding this matter, TSS's Director stated that she was aware of the potential conflict of interest caused by the lack of segregation of duties but that during the audit period, she was the only administrative employee at the school, preventing her from delegating any of the day-to-day responsibilities to other staff members.

Nevertheless, as a result of the lack of segregation of duties, the Commonwealth and TSS cannot be adequately assured that the funds TSS received from the Commonwealth were appropriate or that TSS's expenditures were reasonable and allowable.

Recommendation

TSS should develop and implement adequate written policies and procedures that include all aspects of its accounting operations and are in compliance with GAAP and the Commonwealth's Terms and Conditions for Human and Social Services. Moreover, TSS should ensure that it maintains its records for a period of seven years, as required by state regulations. It should also establish controls over the authorization and payment of agency expenses; at a minimum, those controls should include maintaining invoices and receipts for all purchases, clearly indicating the business nature of each expense.

TSS should also take measures to immediately establish a Board of Directors in accordance with the General Laws. The Board of Directors should elect officers; set overall corporate policy; hold regular meetings, including an annual meeting to elect officers; and keep meeting minutes, which should be signed and dated by the Clerk of the board.

Finally, TSS should develop and implement an adequate internal control structure that ensures that all accounting, finance, and related activities are properly segregated. This will ensure that its financial records are properly maintained and its financial activities are properly authorized, recorded, and reported.