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INDEPENDENT STATE AUDITOR'S REPORT ON
CERTAIN ACTIVITIES OF
VALLEY EDUCATIONAL SERVICES, INC.,
D/B/A VALLEY WEST DAY SCHOOL
JULY 1, 2002 TO JUNE 30, 2005

OFFICIAL AUDIT REPORT

MAY 1, 2006

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Valley Educational Services, Inc., D/B/A Valley West Day School (Valley West) was founded in 1994 as a for-profit organization for the purposes of operating a school for students with special needs. During the period covered by our audit, Valley West was licensed by the state's Department of Education (DOE), employed 52 full-time staff members, and served approximately 99 students in day school and summer school programs. These students, who range in age from five to 18 years, are individuals who are experiencing social/emotional problems and whose alternative programming within a public school setting has been unsuccessful.

The scope of our audit was to examine various administrative and operational activities of Valley West during the period July 1, 2002 to June 30, 2005. Our audit was conducted in accordance with generally accepted government auditing standards for performance audits issued by the Comptroller General of the United States and included such audit procedures and tests as considered necessary to meet these standards. Our audit procedures consisted of: (1) determining whether Valley West had implemented effective internal controls over its operations and (2) assessing Valley West's business practices and its compliance with applicable laws, rules, and regulations, as well as the various fiscal and programmatic requirements of its state contracts.

Our audit identified expenses incurred by Valley West totaling $897,414 that were unallowable in accordance with state regulations.

From July 1, 2000 to November 30, 2005, Valley West leased property from its Chief Executive Officer (CEO), a related party, that Valley West used to house its school for special needs students. However, Valley West's lease payments exceeded by $439,416 the allowable limits established by state regulations for payments made to a related party.

We found that during the period July 1, 2002 to November 18, 2005, Valley West paid the wife of its CEO a total of $394,737 in compensation and fringe benefits to function as a Direct Care Consultant for the school. However, Valley West could not supply us with documentation to support that this individual had provided any services that directly benefited the school's day school and summer school programs. As a result, her compensation and fringe benefits, which were paid for with state funds, constitute nonreimbursable costs to the Commonwealth.

We found that during the period January 13, 2003 to November 4, 2005, Valley West leased a vehicle for its CEO and used Commonwealth funds totaling $30,609 to cover monthly lease payments and other related vehicle expenses. However, Valley West could not provide documentation to substantiate that the Chief Executive Officer used the vehicle for school-related purposes. Moreover, Valley West's policies and procedures do not provide for the provision of this fringe benefit to this individual, and the related Board of Directors meeting minutes do not reflect any board authorization for this benefit. According to state regulations, undocumented and non-program-related expenses such as these are considered nonreimbursable costs to the Commonwealth.

We found that during the period July 1, 2002 through December 11, 2005, Valley West used $32,652 in Commonwealth funds to pay for various administrative expenses such as cellular phones for family members of Valley West's CEO, meals, travel costs, and donations that were not related to the social service program activities of Valley West. According to state regulations, expenses such as these are unallowable and nonreimbursable.

INTRODUCTION

Background

Valley Educational Services, Inc., D/B/A Valley West Day School (Valley West) was founded in 1994 as a for-profit organization for the purposes of operating a school for students with special needs. Valley West is licensed by the Commonwealth's Department of Education (DOE) and operates a private school for students who are experiencing social/emotional problems and whose alternative programming within a public school setting has been unsuccessful. During the period covered by our audit, Valley West employed 52 full-time staff and served approximately 99 students in day school and summer school programs. The students range in age from five to 18 years.

Valley West's funding is derived primarily from student tuition payments made by local cities and towns. The Commonwealth's Operational Services Division (OSD), the state agency responsible for regulating the activities of state-licensed special education schools such as Valley West, annually sets the school's tuition rate. For fiscal year 2005, the tuition rate established by OSD for Valley West was $177 per student per day, or $31,954 per student per year. Local cities and towns that enroll students at Valley West fund their tuition payments with money provided to them under the provisions of Chapter 70 of the Massachusetts General Laws, which they receive from the Commonwealth for primary and secondary education, including special needs education. Although the majority of Valley West's income is derived from these tuition payments, because it is a residential school approved in accordance with DOE regulation 603 Code of Massachusetts Regulations (CMR) 18.00 and has its tuition rates established by OSD, it is subject to OSD's regulations. During our audit period, Valley West received the following funding:

	Fiscal Year 2003	Fiscal Year 2004	Fiscal Year 2005
Local Tuition Payments	$3,117,031	$3,143,854	$3,395,104
Other Revenue	6,153	2,760	20
Other Grants	-	633	1,497
Total	$3,123,184	$3,147,247	$3,396,621

Audit Scope, Objectives, and Methodology

The scope of our audit was to examine various administrative and operational activities of Valley West during the period July 1, 2002 to June 30, 2005. However, in some instances it was necessary for us to extend the period covered by our audit in order to adequately examine certain transactions that were selected for testing during our review.

Our audit was conducted in accordance with generally accepted government auditing standards for performance audits issued by the Comptroller General of the United States, and included such audit procedures and tests as considered necessary to meet these standards.

Our audit procedures consisted of the following:

1. A determination of whether Valley West had implemented effective internal controls, including:

    - Processes for planning, organizing, directing, and controlling program operations;

    - Policies and procedures to ensure that resource use is consistent with laws and regulations; and

    - Policies and procedures to ensure that resources are safeguarded and efficiently used.

2. An assessment of Valley West's business practices and its compliance with applicable laws, rules, and regulations, as well as the various fiscal and programmatic requirements of its state contracts.

In order to achieve our objectives, we first assessed the internal controls established and implemented by Valley West over its operations. The purpose of this assessment was to obtain an understanding of management's attitude, control environment, and the flow of transactions through Valley West's accounting system. We used this assessment in planning and performing our audit tests. We then held discussions with Valley West officials and reviewed organization charts, internal policies and procedures, as well as applicable laws, rules, and regulations. We also examined Valley West's financial statements, budgets, cost reports, and invoices to determine whether expenses incurred under its state contracts were reasonable; allowable; allocable; properly authorized and recorded; and in compliance with applicable laws, rules, and regulations.

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

Valley West under its state-funded special education programs. Rather, our objective was to report findings and conclusions on the extent of Valley West's compliance with applicable laws, rules, regulations, and contractual agreements, and to identify services, processes, methods, and internal controls that could be made more efficient and effective.

AUDIT RESULTS

1. UNALLOWABLE LEASE PAYMENTS TOTALING $439,416 PROVIDED TO VALLEY WEST'S CHIEF EXECUTIVE OFFICER

From July 1, 2000 to November 30, 2005, Valley Educational Services, Inc., D/B/A Valley West Day School (Valley West) leased property from its Chief Executive Officer (CEO), a related party, that Valley West used to house its school for special needs students. However, Valley West's lease payments exceeded by $439,416 the allowable limits established by state regulations for payments made to a related party.

In 808 Code of Massachusetts Regulations (CMR) 1.02, the Operational Services Division (OSD) has promulgated regulations that define a related party as follows:

> *Any person or organization satisfying the criteria for a Related Party published by the Financial Accounting Standards Board in Statement of Financial Accounting Standards No. 57 (FASB 57).*

Moreover, Financial Accounting Standards Board (FASB) Statement No. 57, Related Party Disclosures, 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.*

In July 2000, Valley West entered into a five-year agreement with its CEO to lease property that he owned. Valley West uses the property, which is located at 269 Moore Street, Chicopee, for the operation of its special education day school and summer school programs. Under the terms and conditions of the agreement, the lease was for a five-year period effective July 1, 2000. The agreement also provided Valley West with an option to renew the lease for an additional five years, which the school exercised on July 1, 2005.

Under the original lease, Valley West agreed to make monthly payments to the CEO that totaled $510,000 through June 30, 2005. In addition, Valley West's current lease agreement with the CEO calls for lease payments totaling $660,000 through June 30, 2010. As part of the lease agreements, Valley West was also responsible for all building-related expenses, such as utilities, structural repairs, capital improvements, liability insurance, and real estate taxes.

We believe that Valley West's ongoing activities with the CEO constitute a related-party relationship as defined by FASB Statement No. 57 for the following reasons:

- The CEO owns both Valley West and the building that he is leasing to Valley West.
- For fiscal years 2002 through 2005, Valley West's Financial Statements and Supplemental Information, which were prepared by the school's independent auditors, reported that these lease agreements represent a related-party relationship.

As a consequence of its related-party relationship with its CEO, Valley West must comply with regulations promulgated by OSD regarding related-party transactions. Specifically, 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.*

During our audit, we noted that Valley West violated OSD regulations governing related-party transactions. Specifically, for the period July 1, 2000 to November 30, 2005, Valley West made lease payments totaling $562,000, while the CEO's cost to own and maintain the facility for the same period totaled only $122,584. The difference between the total lease payments of $562,000 and the CEO's cost to own the property represents an unallowable cost of $439,416 that Valley West charged as occupancy expenses under special education programs that were paid for with state funds. The table below details Valley West's overpayments to its CEO for the lease of this property during the period July 1, 2000 to November 30, 2005.

Overpayments to Related Party

	Fiscal Year 2001	Fiscal Year 2002	Fiscal Year 2003	Fiscal Year 2004	Fiscal Year 2005	Fiscal Year 2006 **	Total
Lease Payments:	$84,000	$104,000	$102,000	$108,000	$114,000	$50,000	$562,000
Allowable Costs:							
Interest*	15,290	15,136	14,969	14,790	14,598	6,023	80,806
Depreciation	7,713	7,713	7,713	7,713	7,713	3,213	41,778
Total Allowable Expenses	$23,003	$22,849	$22,682	$22,503	$22,311	$ 9,236	$122,584
Overpayment	$60,997	$81,151	$79,318	$85,497	$91,689	$40,764	$439,416

* Interest was calculated at 7.25% and amortized over 30 years using a principal of $212,000. Interest costs were calculated using BankRate.com.

**Fiscal year 2006 through November 30, 2005.

Regarding this matter, Valley West's CEO stated that he was unaware of the Commonwealth's regulations governing related-party transactions. Moreover, the CEO indicated that Valley West's monthly lease payments were based upon market rates in the local area, which he believed were reasonable. However, clearly it is the responsibility of Valley West to be aware of and fully comply with all applicable state regulations governing its activities.

Recommendation

In order to address our concerns relative to this matter, the Commonwealth should recover from Valley West the $439,416 in unallowable lease payments that it made to its related party. In the future, Valley West should take measures to ensure that it fully complies with the OSD's regulations relative to related party transactions.

Auditee's Response

The auditor's report does not allow for repayment of personal funds used to purchase and renovate the building.

Using a July 7, 2004, appraisal conducted by the firm of Crowley & Associates, Springfield, MA, Valley West School was compared with thirteen similarly used properties within the area. The fair market for rental space as recommended by Crowley & Associates would be $9.00 a square foot. Based on the independent firm's assessment, the total rent for a year would be $149,409.00 for a 16,601 square foot building.

Using the indicated allowable costs shown in the auditor's report for the fiscal year 2005 of $22,311.00, rental cost for the 16,601 square foot building would be $1.34 a square foot.

Valley West School's fiscal year 2005 rental payment of $114,000 represents a square footage charge of $6.91 a square foot, which is $2.09 below Crowley & Associates recommended rate.

Based on the above and Valley West School's full disclosure of related party transactions in its yearly UFR filings with the Department of Education, Valley West School believes the current lease is appropriate.

Auditor's Reply

Contrary to what Valley West states in its response, our report does in fact correctly allow for the repayment of the personal funds that were used by the agency's CEO to purchase the building. Specifically, the figures we used to calculate the allowable amounts that could be reimbursed to Valley West's CEO in this related-party transaction included an amount for depreciation on the assets, including the building, that were purchased by the CEO with his personal funds. In contrast, the agency's own financial records indicate that the renovations to the property in question were paid for with tuition and other revenues received by Valley West. Consequently, we did not include in the allowable amounts that could reimbursed to Valley West's CEO a depreciation amount for these assets, since school, rather than personal, funds were used for to pay for these renovations.

In its response, Valley West refers to a July 7, 2004 appraisal conducted by a local real estate appraiser in which the agency contends the appraiser determined a fair market rental price for the school. However, this appraisal is not relevant to our analysis. Specifically, as noted in our report, 808 CMR 1.05(8) promulgated by OSD states that related-party transactions 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. Since the CEO's actual costs were lower than what appears to be fair market rent for this property, in accordance with OSD regulations, we used these actual costs in our analysis to determine the extent to which Valley West's payments for this property exceeded what was allowable. As noted in our report, based on our analysis, Valley West's payments exceeded the related party's actual costs by $439,416. Consequently, Valley West should remit this amount to the Commonwealth.

2. UNALLOWABLE COMPENSATION TOTALING $394,737 PROVIDED TO THE WIFE OF VALLEY WEST'S CHIEF EXECUTIVE OFFICER

We found that during the period July 1, 2002 to November 18, 2005, Valley West paid the wife of its CEO a total of $394,737 in compensation and fringe benefits to function as a direct care consultant for the school. However, Valley West could not supply us with documentation to support that she had provided any services that directly benefited the school's day school and summer school programs. As a result, her compensation and fringe benefits, which were paid for with state funds, constitute nonreimbursable costs to the Commonwealth.

808 CMR 1.05, promulgated by OSD and applicable to programs approved by the Department of Education (DOE) under Chapter 71B of the General Laws, such as Valley West, identifies the following as nonreimbursable costs to the Commonwealth:

> *(1)Unreasonable Costs. Any costs not determined to be Reimbursable Operating Costs as defined in 808 CMR 1.02 or any amount paid for goods or services which is greater than either the market price or the amount paid by comparable Departments or other governmental units within or outside of the Commonwealth.*
>
> *(12)Non-Program Expenses. Expenses of the Contractor which are not directly related to the social service Program purposes of the Contractor.*
>
> *(26)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 the wife of Valley West's CEO was being paid to function as a direct care consultant for Valley West. Our review of the direct care consultant's personnel file and our observations of her activities within the school revealed several problems. First, her personnel file did not contain a job application or resume detailing her qualifications for the direct care consultant position. In addition, this file did not contain a contract or other legal documents authorizing her employment or establishing her rate of compensation, or an annual employee evaluation as was available for all other Valley West employees tested. Second, during the period of our on-site fieldwork (September 18, 2005 to December 15, 2005), we did not observe her working or occupying office space within the school. Third, Valley West could not provide us with any documents (e.g., agendas, proposals, reports) indicating that she provided any services that directly benefited the school. Consequently, Valley West cannot support its use of state funds totaling $394,737 for this position. The table below details the unallowable compensation and fringe benefits paid to the CEO's wife from July 1, 2002 to November 18, 2005.

Valley West's Fringe Benefit Contributions

Fiscal Year	Employee Compensation	Social Security	Medicare	Profit Sharing	Total
2003	$ 77,500.80	$4,804.80	$1,123.72	$ 35,182.44	$118,611.76
2004	77,527.20	4,806.56	1,124.16	35,351.33	118,809.25
2005	77,532.00	4,806.88	1,124.24	40,146.83	123,609.95
2006 *	31,311.00	1,941.24	454.02	-	$ 33,706.26
Total	$263,871.00	$16,359.48	$3,826.14	$110,680.60	$394,737.22

*Fiscal year 2006 through November 18, 2005.

Regarding this matter, Valley West's CEO acknowledged the deficiencies within his wife's personnel file and confirmed that she does not maintain regular office hours, submit weekly time sheets, or prepare written products reflecting her services for the school. Regarding her job qualifications, the CEO stated that his wife holds a Bachelor of Science degree as well as a teaching certificate from DOE. However, the CEO could not provide us any documents to support his wife's role at the school.

Recommendation

In order to address our concerns relative to this matter, we recommend that the Commonwealth recover the $394,737 that Valley West paid in unallowable and unreasonable compensation and fringe benefits to the CEO's wife. Furthermore, DOE, in conjunction with OSD, should review Valley West's payroll records for the periods prior to our audit period, determine whether additional state funds should be recovered, and take whatever actions they deem appropriate to resolve this matter. In the future, Valley West should take measures to ensure that it does not use Commonwealth funds to pay for such unallowable expenses.

Auditee's Response

The wife of the CEO was a co-founder of the school and serves as a direct care consultant. She provides Valley West School with invaluable service ranging from the establishment of the school, its structure, the hiring of personnel, purchasing of equipment and supplies, establishment of salary schedules, selection of school sites and major decisions regarding the overall operation of the school. As defined in the job description found in her personnel file she performs the following functions:

- *Serves on the Board of Directors*
- *Performs bookkeeping duties associated with the corporation*
- *Assist in developing school programs.*
- *Assist in maintaining the fiscal strength and viability of the corporation.*
- *Assist in developing, monitoring, and revising the annual budget during the fiscal year.*
- *Assist in evaluating and modifying programs and services to maintain efficiency and effectiveness.*
- *Assist in developing and modifying organization structure and personnel policies and procedures.*
- *All other duties as assigned by the Director*

In response to the auditor's comments regarding the CEO's wife's personnel file:

1. *As a co-founder of the school with 28 years of public school teaching experience, to whom would a job application or resume be submitted to?*
2. *All employees of Valley West School are employees at will and do not have contracts.*
3. *Consultants do not occupy space in the building, nor do they have regular hours.*

Auditor's Reply

We do not dispute that the wife of Valley West's CEO was a co-founder of the school. However, simply being a co-founder of the agency does not entitle one to receive compensation from the agency without providing any services. Our concerns are that this individual did not have a clearly defined role within the agency in terms of being a consultant or an employee, and that Valley West could not provide us with any documentation to indicate that she provided any of the services that were detailed in her job description during the period covered by our audit, and was therefore entitled to all of the compensation she was provided by Valley West. In its response, Valley West contradicts itself when trying to explain this individual's role within the agency. Specifically, the agency first states that this individual functioned as a "direct care consultant" to the agency. However, Valley West has no documentation to substantiate this assertion, in that there were no consultant contracts entered into between this individual and Valley West that clearly delineated the terms and conditions of her employment or her rate of compensation. Further, as a consultant, OSD regulations would require this individual to submit invoices that documented the types and amounts of services she provided in order to be compensated for these services. However, no such invoices were ever submitted by this individual. Moreover, our review of agency records indicated that this individual was paid as an employee through Valley West's payroll system, and was provided with certain benefits, such as pension benefits, that were only available to employees.

In contrast, later on in its response, Valley West refers to this individual as an employee, rather than a consultant, by stating that employees do not have contracts. However, if this is in fact the case, this individual was not treated like any other Valley West employee, in that she did not have an assigned workspace or established working hours. In fact, as stated in our report, during our entire time working on site at Valley West, we did not observe this individual working at the school. In addition, this individual was not held to the same employment standards as other Valley West employees. Specifically, during our audit we reviewed the personnel files of at least 12 other Valley West employees and noted that these files all contained job applications, résumés, annual job performance evaluations, and other payroll and employment records. However, the personnel file of the wife of Valley West's CEO did not contain any performance evaluations, resume, job application, and other personnel and payroll documents that were contained in the employee files that we reviewed. Further, her job title of Direct Care Consultant does not appear on Valley West's organization chart as being a recognized employee position within the agency. If in fact, this individual was considered an employee of Valley West, we question why she was not held to the same standards as other agency employees.

Valley West concludes its comments by again referring to this individual as a consultant by stating, "Consultants do not occupy space in the building, nor do they have regular hours." Again, if this individual is in fact a consultant, we question why she is being given benefits and is being paid through Valley West's payroll as if she were a regular employee, and is purportedly involved in making key operational decisions in the areas of programming, budgeting, and recruiting that are normally reserved for full-time management staff.

In its response, Valley West also asserts that the CEO's wife provides a variety of services, such as hiring of personnel, purchasing equipment and supplies, and assisting in the establishment of salary schedules. However, during our audit, Valley West could not provide us with any documentation to substantiate that this individual performed any of these tasks. Moreover, we noted that Valley West employs full-time staff that appear to perform all of the functions that are purportedly performed by this individual. For example, Valley West has a full-time Human Resources Director, who coordinates all hiring and the establishment of salaries with the agency's CEO, and a full-time Business Manager, who is responsible for purchasing equipment and supplies. In addition, Valley West has a full-time Business Manager who manages all of the agency's bookkeeping activities. In its response, Valley West's also asserts that the CEO's wife is required to serve on Valley West's Board of Directors. However, since Valley West's board minutes do not list the board members in attendance at each meeting, it was not possible to substantiate this assertion from the agency's records.

Clearly, if the CEO's wife is providing services to Valley West as either a consultant or full-time employee, the agency is required by state regulations to maintain documentation to substantiate this fact. Since Valley West could not provide us with any records showing the hours that this individual worked or any services that this individual may have provided during the period covered by our audit, the compensation the agency provided to this individual is clearly unallowable in accordance with state regulations and should be remitted to the Commonwealth.

3. UNALLOWABLE VEHICLE EXPENSES TOTALING $30,609

We found that during the period January 13, 2003 to November 4, 2005, Valley West leased a vehicle for its CEO and used Commonwealth funds totaling $30,609 to cover the monthly lease payments and other vehicle-related expenses. However, Valley West could not provide documentation to substantiate that the CEO used the vehicle for school-related purposes. Moreover, Valley West's policies and procedures do not provide for the provision of this fringe benefit to this individual, and the related Board of Directors meeting minutes do not reflect any board authorization of this benefit. According to state regulations, undocumented and non-program-related expenses such as these are considered nonreimbursable costs to the Commonwealth.

OSD has promulgated regulations, which are applicable to special education schools such as Valley West, that define certain costs that are unallowable and nonreimbursable costs to the Commonwealth. Specifically, 808 CMR 1.05 (9), (12), and (26) defines the following costs as nonreimbursable program costs:

> *Certain Fringe Benefits. Fringe benefits determined to be excessive in light of salary levels and benefits of other comparable Contractors and fringe benefits to the extent that they are not available to all employees under an established policy of the Contractor. Disparities in benefits among employees attributable to length of service, collective bargaining agreements or regular hours of employment shall not result in the exclusion of such costs. . .*
>
> *Non-Program Expenses. Expenses of the Contractor which are not directly related to the social service Program purposes of the Contractor.*
>
> *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 the period January 13, 2003 to November 4, 2005, Valley West leased a 2003 Honda Odyssey, which was used exclusively by its CEO and his wife. However, our review found that Valley West has not established adequate controls over this vehicle, which resulted in its charging unallowable vehicle expenses totaling $30,609 to the Commonwealth. In this regard, Valley West's policies and procedures do not require the CEO to maintain a vehicle log detailing his business versus personal use. Consequently, Valley West could not provide documentation to support that the CEO and his wife used the vehicle for the school's benefit.

The table below details the expenses incurred by Valley West relative to this vehicle from January 13, 2003 to November 4, 2005.

Fiscal Year	Lease Costs	Insurance Costs	Gas, Tolls, Maintenance Costs	Total Costs
2003	$ 3,876	$1,806	$ 210	$ 5,892
2004	6,794	1,925	980	9,699
2005	5,971	1,880	3,495	11,346
2006 *	2,363	-	1,309	3,672
Total	$19,004	$5,611	$5,994	$30,609

*Fiscal year 2006 through November 4, 2005.

During the audit, the CEO stated that his actual usage of the vehicle has been split evenly between business and personal use. However, the CEO could not provide us with the necessary documentation (e.g., mileage log, travel vouchers) to support this assertion. In fact, the CEO had difficulty recalling any business use of the vehicle when we questioned him on the matter. Finally, the CEO stated that Valley West does not plan to renew the lease, which was scheduled to expire in January 2006.

Given that Valley West was unable to demonstrate that this vehicle was used for school purposes, in accordance with state regulations, the $30,609 that Valley West incurred in vehicle expenses represents a nonreimbursable cost to the Commonwealth.

Recommendation

In order to address our concerns relative to this matter, we recommend that Valley West reimburse the Commonwealth the $30,609 in state funds that it used for unallowable vehicle expenses. In addition, Valley West should develop travel policies and procedures to ensure that Commonwealth funds are used for allowable vehicle expenses, only.

Auditee's Response

> *The auditor's statement that, "the CEO had difficulty recalling any business use of the vehicle," is not accurate. The vehicle was used for transportation of students, field trips, purchase of school supplies and equipment.*
>
> *Internal controls are now in place to accurately document and substantiate employee travel expenses.*

Auditor's Reply

During our audit we spoke to Valley West's CEO regarding the personal and business use of the vehicle in question. During this meeting, the CEO was in fact not able to identify specific times when the vehicle was used for business purposes. Although in its response, Valley West asserts that the vehicle in question was used for business purposes, the agency was unable to provide us with any documentation to substantiate this fact.

4. UNALLOWABLE ADMINISTRATIVE EXPENSES TOTALING $32,652

We found that during the period July 1, 2002 through December 11, 2005, Valley West used $32,652 in Commonwealth funds to pay for various administrative expenses, such as cellular phones for family members of Valley West's CEO, meals, travel costs, and donations, that were not related to the social service program activities of Valley West. According to state regulations, expenses such as these are unallowable and nonreimbursable.

The 808 CMR 1.05, promulgated by OSD, identifies the following as nonreimbursable costs for special education schools such as Valley West:

<u>(12) Non-Program Expenses.</u> Expenses of the Contractor which are not directly related to the social service Program purposes of the Contractor.

<u>(23) Luxury Items.</u> All costs associated with luxury items including but not limited to luxury passenger automobiles as defined in the Internal Revenue Code §§ 4001 or 4002, airplanes, boats, vacation homes, alcoholic beverages, charitable contributions and donations, and all non-Program entertainment expenses.

<u>(26) Undocumented Expenses</u>. Costs which are not adequately documented in the light of the American Institute of Certified Public Accountants statements on auditing standards for evidential matters.

Despite these regulatory requirements, during our review of Valley West's administrative expenses we found at least $32,652 in expenses incurred by Valley West during our audit period that were unallowable in accordance with 808 CMR 1.05, as follows:

a. Cellular Phones

From July 1, 2002 through June 30, 2005, Valley West paid cellular phone charges totaling $7,883. Our review found that these charges resulted solely from cellular phones that the school provided to the CEO, his wife, and two children. Although each family member is employed by Valley West (as CEO, direct care consultant, and teaching instructors), the school could not provide documentation to support the business use of these phones. Consequently, the cellular phone charges represent non-program-related and undocumented expenses, which according to OSD regulations are nonreimbursable costs.

b. Donations

From August 14, 2002 to November 4, 2005, Valley West made cash donations to various fundraising events totaling $11,558. These donations, which ranged in amounts from $50 to $700, were provided to nonprofit organizations, municipal unions, public school athletic teams, and other miscellaneous organizations. Based upon 808 CMR 1.05 (23), such donations are considered luxury items and represent nonreimbursable costs to the Commonwealth.

c. Meals and Entertainment

From September 11, 2002 through December 11, 2005, Valley West incurred $12,258 in meal and entertainment costs. Of this amount, only $1,547 (13%) directly benefited Valley West's program operations. For example, on February 27, 2003, the CEO spent $231 on a dinner meeting with staff to discuss various school matters. However, the remaining $10,711 (87%) was spent on non-school-related activities, including personal meals, holiday parties, and golf outings. For example, on June 17, 2005, Valley West held an employee golf outing that cost the school $766. Consequently, based upon 808 CMR 1.05 (12), the $10,711 spent by Valley West on personal meals and non-school-related entertainment represents non-program-related expenses, and as such are nonreimbursable costs to the Commonwealth.

d. Travel

On December 6, 2002, Valley West made a $2,500 lump-sum payment to the CEO for his travel costs for the period December 2001 to December 2002. However, the CEO neither maintained a travel log nor prepared travel vouchers detailing his business-related travel during this period. Without such documentation, Valley West did not have a basis for providing the $2,500 payment to the CEO. Moreover, based upon OSD regulations, the $2,500 amount represents an undocumented expense, which constitutes a nonreimbursable cost to the Commonwealth.

During our audit, we brought these four questionable matters to the attention of the CEO, who indicated that Valley West's internal control policies have been updated to ensure that all future expenses allocated to its special education programs are thoroughly documented and program related.

Recommendation

In order to address our concerns relative to this matter, we recommend that the Commonwealth recover the $32,652 in unallowable administrative expenses that Valley West incurred during the audit period. Moreover, Valley West should continue developing policies and procedures to ensure that its expenditures of state funds are adequately documented and directly benefit the school's special education programs.

Auditee's Response

a. Cellular Phones

Valley West School has implemented internal controls to differentiate between business and personal use of cellular phones.

b. Donations

In order to establish and maintain relations with various community agencies and charities, the school supports the fund raising activities of those groups. The Commonwealth has classified this support as donation, while in fact, they are advertising costs. For example, police and fire department "donations" are used to purchase advertising in their publications.

c. Meals and Entertainment

Valley West School believes that the $10,711 under question was spent on school related activities. The meals, holiday parties and golf outings were used to promote staff morale, create a positive work environment, and to maintain relationships with various individuals who have provided services to the school. . . .

The staff golf outing, held annually, is designed to promote unity, bolster morale, and reward staff for services rendered. This translates into a positive work environment which benefits our students.

d. Travel

The $2500.00 lump sum payment made to the CEO for the period December 2001 to December 2002 was for mileage costs. Internal controls are now in place to accurately document and substantiate employee travel expenses.

Auditor's Reply

In its response, Valley West's indicates that it has taken corrective action regarding the use of its cellular phones. However, since any measures that it may have taken were done after the completion of our audit field work, we cannot comment on their adequacy. During our audit, we did note that once we brought this matter to the attention of the agency's CEO, he reimbursed the school for its monthly cell phone charges for fiscal year 2006 through November 21, 2005. If Valley West continues to maintain cellular phones, it should keep proper documentation to support the business use of these phones.

Contrary to what Valley West states in its response, the Commonwealth did not classify the agency's expenditures. As noted in our report, from August 14, 2002 to November 4, 2005, Valley West made cash donations to various fundraising events totaling $11,558. According to state regulations, donations such as these are nonreimbursable costs to the Commonwealth. Although we do not take issue with Valley West's decision to support local organizations and charities, Commonwealth funds cannot be used for these purposes.

In its response, Valley West contends that the $10,711 in expenses related to meals and entertainment was in fact for school-related activities. However, the agency did not have documentation to substantiate this assertion. Therefore, these expenses are nonreimbursable in accordance with OSD regulations. We do not dispute that some work- sponsored social activities may serve to improve staff morale. However, we believe that it would be more appropriate to spend such funds on activities that involve the students in the school as well as staff, as opposed to such items as dinners at Foxwoods Casino, the Sheraton Hotel, and several restaurants located in New Jersey, which were included in this $10,711 amount and clearly had no benefit to the children in Valley West's program.

In its response, Valley West contends that the $2,500 lump-sum payment was made to the CEO for his mileage expenses. However, the agency was not able to provide us with any documentation to substantiate this assertion. Consequently, as noted in our report, these expenses are nonreimbursable under OSD regulations.