



The Commonwealth of Massachusetts

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**INDEPENDENT STATE AUDITOR'S REPORT ON
CERTAIN ACTIVITIES OF
THE KID'S PLACE, INC.
JANUARY 1, 2005 TO DECEMBER 31, 2006**

**OFFICIAL AUDIT
REPORT
FEBRUARY 14, 2008**

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The Kid's Place, Inc., (TKP) located in Wilbraham, Massachusetts, was incorporated on May 21, 1982 as a private, for-profit early childhood day care center. TKP operates three types of programs: infant/toddler day care, preschool day care, and a child care food program.

TKP is licensed by the Department of Early Education and Care to provide childcare services to up to 872 children (153 infant/toddler, and 719 preschool) at seven locations in Western Massachusetts, as well as an out of state childcare program. TKP leases all of its childcare centers from a related-party company, O'Day Associates, LLC, which is owned by the President of TKP.

The scope of our audit was to examine various administrative and operational activities of TKP during the period January 1, 2005 to December 31, 2006, including an assessment of TKP's internal controls and business practices, and its compliance with applicable laws, rules, regulations, and the various fiscal and programmatic requirements of its state contracts.

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1. NON-REIMBURSABLE RELATED PARTY COSTS TOTALING \$58,661 CHARGED TO THE COMMONWEALTH

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During the period covered by our audit, TKP leased its seven Massachusetts day care centers and the space that houses its administrative office from a company owned by TKP's President. We compared the rental payments made by TKP to O'Day Associates LLC to the actual costs O'Day incurred relative to the operation of these properties, as indicated in its annual audited financial statements. Our analysis revealed for fiscal years 2005 and 2006, the amount of lease payments made by TKP to O'Day exceeded the amounts allowed by OSD regulations by \$58,661.

2. UNALLOWABLE COMPENSATION TOTALING \$53,981 CHARGED TO STATE CONTRACTS

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During our audit period, TKP charged compensation for its administrative staff to its state contracts that exceeded the amount allowed by state regulations by \$53,981. We also found that the Uniform Financial Statements and Independent Auditor's Reports (UFRs) that TKP filed with the Commonwealth during our audit period misrepresented the actual number of administrative staff TKP was utilizing. Specifically, TKP's UFRs for fiscal years 2005 and 2006 indicated that TKP utilized 10.15 full-time equivalent (FTE) staff for various administrative positions. However, we found that, contrary to Operational Services Division (OSD) guidelines, the company's President was actually performing the tasks and receiving additional compensation for at least 2.66 of these FTE positions. Because TKP did not accurately report the number of administrative staff it was utilizing, the Commonwealth and other users of the UFR information were not given all the information necessary to accurately assess TKP's performance.

INTRODUCTION

Background

The Kid's Place, Inc, (TKP), located in Wilbraham, Massachusetts, was incorporated on May 21, 1982 as a private, for-profit early childhood day care center. TKP's stated goals are to provide quality child care services that are based on sound educational philosophies; create a warm, nurturing environment where children are accepted for the unique individuals they are; and challenge children to develop socially, emotionally, and cognitively. TKP operates three types of programs: infant/toddler day care, preschool day care, and a child care food program.

TKP is licensed by the Department of Early Education and Care (DEEC) to provide childcare services to up to 872 children (153 infant/toddler, and 719 preschool) at seven locations located in Western Massachusetts, as well as an out of state childcare center. TKP leases all of its childcare centers from a related-party company, O'Day Associates, LLC, which is owned by the President of TKP.

During the audit period, TKP received its revenues from several sources, including DEEC's state contracts, DEEC's voucher funding, Massachusetts-subsidized parent fees, Department of Education nutrition funding, and private client sources, as follows:

The Kid's Place, Inc			
Summary of Revenue			
Fiscal Years 2005 and 2006¹			
Revenue Source	FY 2005	FY 2006	Total
DEEC Voucher	\$2,071,735	\$2,090,912	\$4,162,647
DEEC Contract	311,599	388,084	699,683
Private Client Fees	1,242,535	1,185,540	2,428,075
Publicly Sponsored Client Fees	85,569	89,519	175,088
Publicly Sponsored Client Offsets ²	320,549	312,981	633,530
Other Revenue	276,153	221,282	497,435
Interest	8,199	45,728	53,927
Out of State	<u>1,503,904</u>	<u>1,427,122</u>	<u>2,931,026</u>
Totals	<u>\$5,820,243</u>	<u>\$5,761,168</u>	<u>\$11,581,411</u>

¹ Although the Commonwealth operates on a fiscal year ending June 30th, The Kid's Place fiscal year is the same as the calendar year, ending December 31st of each year.

² Publicly Sponsored Client Offsets is income from state's Child Care Food Program.

Audit Scope, Objectives, and Methodology

The scope of our audit was to examine various administrative and operational activities of TKP during the period January 1, 2005 to December 31, 2006.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence that provides a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Our audit procedures consisted of the following:

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

- a. Processes for planning, organizing, directing, and controlling program operations;
- b. Policies and procedures to ensure that resource use is consistent with Massachusetts laws and regulations and that resources are safeguarded and efficiently used.
- c. An assessment of TKP'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 TKP over its operations. The purpose of this assessment was to obtain an understanding of management's attitude, the control environment, and the flow of transactions through TKP's accounting system. We used this assessment in planning and performing our audit tests. We then held discussions with TKP officials and reviewed organization charts; internal policies and procedures; and all applicable laws, rules, and regulations. We also examined TKP's financial statements, invoices, and other pertinent financial records to determine whether expenses incurred under its state contracts were reasonable; allowable; allocable; properly authorized and recorded; and in compliance with applicable laws, rules, and regulations.

Our audit was not made for the purposes of forming an opinion on TKP's financial statements. We also did not assess the quality and appropriateness of all program services provided by TKP under its state-funded contracts. Rather, our report was intended to report findings and conclusions on

the extent of TKP's compliance with applicable laws, regulations, and contractual agreements, and to identify services, processes, methods, and internal controls that could be made more efficient and effective.

AUDIT RESULTS

1. NON-REIMBURSABLE RELATED PARTY COSTS TOTALING \$58,661 CHARGED TO THE COMMONWEALTH

During the period covered by our audit, The Kid's Place, Inc., (TKP) leased its seven Massachusetts day care centers and the space that houses its administrative office from a company owned by TKP's President. We found, however, that the amount of lease payments charged by TKP to its state contracts exceeded the amount allowed by state regulations by \$58,661.

The state's Operational Services Division (OSD), the state agency responsible for regulating and overseeing the activities of contracted service providers such as TKP, has promulgated 808 Code of Massachusetts Regulations (CMR) relative to related-party transactions. In this regard, OSD defines 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, FASB 57 defines a related party as follows:

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.

Furthermore, OSD has limited the amount of funds that can be paid to related parties in its regulation 808 CMR 1.05(8), which states, in part:

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 found that TKP was leasing the space that housed seven of its daycare centers and its administrative office from O'Day Associates, LLC (O'Day). According to the annual report that it filed with the Secretary of the Commonwealth of Massachusetts, O'Day was

established to “own, operate, lease, buy, and sell real property, ” and the company’s owner is the President of TKP. Therefore, the lease payments made by TKP to O’Day constitute a related-party transaction and are subject to the restraints imposed by OSD regulations.

During our audit, we compared the rental payments made by TKP to O’Day to the actual costs O’Day incurred relative to the operation of these properties, as indicated in its annual audited financial statements. Our analysis revealed that for fiscal years 2005 and 2006, the amount of lease payments made by TKP to O’Day exceeded the amount allowed by OSD regulations by \$58,661, as indicated in the following table:

Fiscal Year	O’Day Rental Income	O’Day Expenses	Resulting Nonreimbursable Cost	Commonwealth* Revenue Percentage	Commonwealth Unallowable Cost
2006	\$ 768,480	\$ 264,986	\$ 503,494	6.7%	\$33,916
2005	<u>746,040</u>	<u>283,834</u>	<u>462,206</u>	5.4%	<u>24,745</u>
Total	<u>\$1,514,520</u>	<u>\$548,820</u>	<u>\$965,700</u>		<u>\$58,661</u>

* This percentage represents the ratio of state contract revenue to the total revenue received by agency during each fiscal year.

OSD has established guidelines for the proper reporting of nonreimbursable costs by human services providers such as TKP. Specifically, OSD’s Uniform Financial Statements and Independent Auditors’ Report (UFR) Audit and Preparation Manual states, in part:

The existence of non-reimbursable costs, as contained in 808 CMR 1.15 (Effective 2/1/97, 808 CMR 1.05) and OMB Circulars A-21 and A-122, must be itemized by natural classification and disclosed in the component and program as applicable. Non-reimbursable costs that exist and have not been disclosed are presumed to have been defrayed using Commonwealth and Federal funds....

This information, taken together with the auditor’s compliance testing of non-reimbursable costs, provides UFR report users with a measure of assurance that all non-reimbursable costs have been defrayed with revenues not derived from public funds or designated by donors for other purposes.

However, we determined that TKP did not properly report these \$965,700 in non-reimbursable related-party expenses on the UFRs that it filed with OSD. Consequently, based upon the ratio of state contract revenue to the total revenue received by TKP during the two fiscal years ended December 31, 2005 and 2006, the Commonwealth was improperly charged \$58,661 of these nonreimbursable expenses.

We discussed this matter with TKP's President, who stated that he was not aware of the OSD regulations concerning related-party transactions. However, he stated that since TKP was a for-profit organization, it was reasonable for him to receive fair market rent for these properties. However, clearly, TKP's President should have been aware of OSD's regulations regarding related-party transactions and should have taken measures to ensure that TKP complied with these regulations.

Recommendation

In order to address our concerns relative to this matter, we recommend that TKP re-file its UFR reports for the two fiscal years ending December 31, 2005 and 2006. As part of this process, TKP should restate its non-reimbursable costs to include the \$58,661 it provided to O'Day in lease payments. In addition, TKP should identify the non-state offsetting revenue available to cover its non-reimbursable expenses. If TKP does not have sufficient non-state revenues to offset these expenses, then OSD should seek recoupment of the portion of state funds that were used to fund these nonreimbursable expenses, which we calculate to be \$58,661. In the future, TKP should take measures to ensure that it fully complies with all applicable regulations, including those relative to related-party transactions.

2. UNALLOWABLE COMPENSATION TOTALING \$53,981 CHARGED TO STATE CONTRACTS

We found that during our audit period, TKP charged to its state contracts compensation for its administrative staff that exceeded the amount allowed by state regulations by \$53,981. We also found that the UFRs that TKP filed with the Commonwealth during our audit period misrepresented the actual number of administrative staff that TKP was utilizing. Specifically, TKP's UFRs for fiscal years 2005 and 2006 indicated that TKP utilized 10.15 full-time equivalent (FTE) staff for various administrative positions. However, we found that, contrary to OSD guidelines, the company's President was actually performing the tasks associated with at least 2.66 of these FTE positions and was receiving the additional compensation associated with these positions. Because TKP did not accurately report the number of administrative staff it was utilizing, the Commonwealth and other users of the UFR information were not given all the information necessary to accurately assess TKP's performance. The specific problems we identified in these areas are discussed below:

a. Unallowable Compensation Totaling \$53,981 Provided to Company Staff

OSD, through its regulations, has established a limit on the amount of Commonwealth funds that may be used to pay the salaries of managers and officers of human service providers, such as TKP, contracting with the Commonwealth. In this regard, 808 CMR 1.05, promulgated by OSD, states, in part:

Funds received from Departments may only be used for Reimbursable Operating Costs as defined in 808 CMR 1.02. In addition, funds may not be used for costs specifically identified in 808 CMR 1.05 as non-reimbursable.

808 CMR 1.05(24), Salaries of Officers and Managers, identifies the following costs as being nonreimbursable:

Salaries of officers and managers to the extent they exceed the rate paid to state managers in job group M-XII, step seven.

The fiscal year 2006 UFR Audit and Preparation Manual issued by OSD includes, as an appendix, a memorandum titled “Policy Guidance/Regulatory Interpretation of 808 CMR 1.05(24) Salaries of Officers and Managers,” which states, in part:

Effective July 1, 1998, the salaries of officers and managers as defined by OSD shall be non-reimbursable under Operational Services Division regulation 808 CMR 1.05(24) as amended to the extent that they exceed an annual rate of \$136,315.73. Contractors must maintain documentation and justification for the selection of a salary reimbursement rate up to \$136,315.73. Where officers and managers devote less than full time to state programs, the level of reimbursement should be prorated accordingly.

Additionally the memorandum states, in part:

Officers and Managers are defined as: Persons who are responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Officers and Managers normally include members of the board of directors, the chief executive officer, chief operating officer, vice president in charge of principal business functions (such as sales, administration, or finance), and other persons who perform similar policymaking functions. Persons without formal titles also may be members of management. In most instances, management of a social service program will include program directors and program managers.

During our audit, we reviewed TKP’s internal controls over payroll. Based on our review, we determined that TKP charged administrative staff salaries to state contracts that exceeded the amount allowed by OSD regulations by \$53,981.

During fiscal years 2005 and 2006, TKP identified \$686,400 of its administrative salaries as being nonreimbursable. However, our audit revealed TKP's non-reimbursable cost for the period totaled \$1,572,368, which means that TKP under-reported to the Commonwealth its nonreimbursable compensation by \$885,968. In addition, based upon the ratio of state contract revenue to the total revenue received by the agency, during this period TKP charged \$53,981 of the nonreimbursable compensation to state contracts.

Regarding this matter, TKP's President stated he was not aware that there was a limit on the amount of compensation that can be paid to managers and officers. However, he stated that the childcare rate his agency receives for each child that it serves was set by the Commonwealth, and that as long as he provides the agreed upon services, he should be allowed to spend the funds as he deems appropriate to operate his company.

b. TKP Did Not Accurately Report Its Administrative Staffing in Its UFRs

OSD has promulgated regulations, 808 CMR 1.04, relative to recordkeeping and reporting requirements for all human service contractors such as TKP. Specifically 808 CMR 1.04 (1) 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); In addition, personnel records shall be maintained for each employee in accordance with generally accepted accounting principles recommended by the AICPA and sufficient to meet the requirements of MGL c 151, the Fair Labor Standards Act of 1938 and contract terms.

The UFR Audit and Preparation Manual issued by the OSD defines a Full Time Equivalent (FTE) as:

A method of measuring the amount of time that a part-time employee works in terms of a full time equivalent holding a comparable job. If 40 hours a week defines a full week, then 40 hours of combined part-time work for a given position is 1.00 FTE and 20 hours is .5 FTE. The full-time work week for any given position should never total to more than 1.00 FTE even if employees consistently work more hours a week than the defined work week. . . . If an employee's work crosses two or more

job categories within one program/cost center, reported FTE time should be split accordingly. . . . FTEs and wages must reconcile so that an employee reported as .65 FTE shows a salary of sixty-five percent of a full-time annual salary. . . . The record keeping requirements of OSD require personnel and payroll records to be maintained in a manner that would facilitate the reporting of FTE information for Commonwealth-purchased programs.

Finally, during our audit we contacted the Director of OSD's Bureau of Audit regarding this matter. In response, he sent us an email on June 13, 2007 that stated, in part:

Often management employees (salaried) in small organizations work more than a set number of hours and have more than one "functional" title and may report by "functional" title, i.e., CEO, CFO and Marketing Services, but the FTE can not exceed 1.00 for the total of the combined positions he or she occupies.

We reviewed the UFRs submitted by TKP to OSD during the period covered by our audit and compared the staffing information in these UFRs with TKP's payroll records. Based on our review, we noted a number of discrepancies between the staffing levels reported by TKP in its UFRs with the actual staff that worked at TKP during the audit period. Specifically, the UFRs filed by TKP during our audit period listed staff positions such as Chief Executive Officer (CEO), Chief Financial Officer (CFO), and a Marketing Services position, with corresponding salaries and FTEs. However, based on TKP's active employee list and organizational chart, TKP's President was performing the tasks associated with these positions. Our review of the 2006 UFR filed by TKP revealed at least 2.66 FTEs, with a corresponding salary of \$260,000 attributed to the President through three different line item positions. The remaining 2006 salary received by the President was allocated both to an accounting/clerical staff line item and a nonreimbursable salary line item, with no definable FTEs attached. The table below details the allocation of the President's salary to the various line items with the corresponding FTEs:

**Summary of Positions Filled by TKP's President
and Fiscal Year 2006 Compensation Received**

Position	FTE Reported	Compensation Reported
Chief Executive Officer	.96	\$100,000
Chief Financial Officer	1.00	100,000
Commercial Products/Marketing	<u>.70</u>	<u>60,000</u>
Totals	<u>2.66</u>	<u>\$260,000</u>

Regarding this matter, TKP's President and a representative from the company's private accounting firm stated that the allocation of the President's salary to various line items is based on an estimate of the amount of work the President performs functioning in each position. The President explained that TKP is his business, and that he performs administrative tasks as needed throughout the day, rather than hiring other people to perform these tasks, in order for the company to run efficiently.

However, because TKP did not accurately report the number of administrative staff it was utilizing, the Commonwealth and other users of the UFR information were not given all the information necessary to accurately assess TKP's performance. Furthermore, the UFRs submitted by TKP during our audit period were not in compliance with the requirements of 808 CMR 1.00.

Recommendation

In order to address our concerns, we recommend that TKP amend the UFRs that it filed with OSD during the period covered by our review to accurately report the additional \$885,968 in non-reimbursable salary expenses it incurred during this period. If TKP does not have sufficient non-state revenues to offset these expenses, then OSD should seek recoupment of the portion of state funds that were used to fund these nonreimbursable expenses, which we calculate to be \$53,981.

Auditee's Response

In response to this report, TKP provided the following response:

As your report correctly points out, we were not as familiar with the technical requirements of the UFR as we should have been and your guidance has been a great help. We are confident that the revised versions of the UFR reports for December 31, 2005 and December 31, 2006 will show sufficient non-state revenues to offset the expenses described in your report.