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INDEPENDENT STATE AUDITOR'S REPORT

ON CERTAIN ACTIVITIES OF THE

COMMUNITY GROUP, INC.

OCTOBER 1, 1996 THROUGH SEPTEMBER 30, 2001

**OFFICIAL AUDIT
REPORT
FEBRUARY 3, 2003**

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Community Group, Inc. (CGI) was organized in Massachusetts on April 21, 1972 as a wholly owned for-profit subsidiary of a publicly held corporation, First Community, Inc. (FCI). CGI provides operational, residential, individual support, and training services for developmentally disabled individuals in several residential facilities throughout eastern Massachusetts and a sheltered training center located in Wakefield.

The scope of our audit was to examine various administrative and operational activities of CGI during the period October 1, 1996 to September 30, 2001. Our audit, which was conducted in accordance with applicable generally accepted government auditing standards for performance audits issued by the Comptroller General of the United States, had the following specific objectives: (1) a determination as to whether CGI had implemented effective management controls and (2) an assessment of CGI'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 highly questionable undocumented and unallowable expenses totaling at least \$1,575,553 undisclosed related-party transactions totaling hundreds of thousands of dollars; unallowable profits charged against state contracts totaling an additional \$463,058, inadequate documentation to substantiate the allocation of \$1,767,768 in administrative payroll expenses; and inadequate internal controls over many aspects of CGI's operations.

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1. HIGHLY QUESTIONABLE RELATED-PARTY TRANSACTIONS TOTALING \$1,121,964 AND UNDISCLOSED RELATED-PARTY TRANSACTIONS TOTALING HUNDREDS OF THOUSANDS OF DOLLARS

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During our audit period, CGI inappropriately transferred at least \$1,121,964 in commercial income that it realized in its state-funded Community Training Center Program (CTCP) to CGI's Executive Director and related organizations owned by the Executive Director. According to state contracting requirements, CGI is required to identify any non-state revenues, including commercial income it received in this program, as being available to offset the cost the state was paying to operate the program. However, we found that CGI did not report any of the \$1,121,964 in commercial income that it received in this program as program revenue in the financial statements it filed with the Commonwealth and did not use any of this commercial income to defray the state's cost of operating this program. Rather, these funds were transferred to non-CGI accounts and used by CGI's Executive Director to pay for personal expenses such as \$210,027 in mortgage costs related to private business ventures; \$74,370 in lease costs for a Mercedes Benz; \$103,920 for dues, restaurant charges, and other expenses at a country club; \$5,500 for laser eye

surgery; \$15,331 for flowers; and \$80,993 in landscaping fees, \$26,654 in electrical service fees, and \$21,156 in home heating oil charges for the Executive Director's personal residence. We also found that, contrary to state regulations, CGI failed to disclose in the financial statements that it filed with the state at least three other related-party transactions involving hundreds of thousands of dollars. As a result, state funding and oversight agencies did not have the ability to adequately assess CGI's activities and performance and were overcharged by as much as \$1,121,964.

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According to state regulations, for-profit contracted service providers such as CGI are required to negotiate the amount of profits they can make on state contracts. We found, however, that in addition to the commercial income CGI retained in its Community Training Center Program, during our audit period CGI retained as much as an additional \$463,058 in profits in excess of what was allowed by its state contracts in its other state-funded programs. As a result, CGI owes \$463,058 of these excessive and unallowable profits to the Commonwealth.

3. DUPLICATE AND UNDOCUMENTED PAYROLL AND OTHER COSTS TOTALING AT LEAST \$264,908 ALLOCATED AGAINST STATE CONTRACTS **27**

We found that during fiscal year 1999, CGI billed and received duplicate payments totaling \$221,426 against its state contracts. We also found that during this fiscal year, CGI allocated an additional \$43,482 in expenses to state contracts that it could not document were actually incurred. According to state regulations, expenses such as these are unallowable and nonreimbursable under state contracts, and therefore CGI should return this \$264,908 to the Commonwealth.

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During fiscal year 2000, CGI charged \$75,000 in management fees to its state contracts for services purportedly provided by CGI's Executive Director on behalf of FCI. However, CGI could not provide us with any documentation to substantiate that these management services were actually provided. According to state regulations, expense such as these that are undocumented or non-program-related are unallowable and nonreimbursable under state contracts, and therefore CGI should return this \$75,000 to the Commonwealth.

5. INADEQUATE CONTROLS OVER THE USE OF CORPORATE CREDIT CARDS RESULTED IN \$75,197 IN UNALLOWABLE CREDIT CARD EXPENSES **33**

During the period October 1, 1998 through September 30, 2000, CGI permitted three members of its administrative staff to use its American Express corporate credit cards. Two of these members also were allowed to use an FCI American Express credit card that was being utilized by CGI to pay for CGI expenses. However, we found that CGI had not established adequate controls over the use of

these credit cards. Our examination of the credit card expenditures made by these staff members during our audit period revealed that 186 expenditures totaling \$75,197 charged to state contracts were questionable in that they were either inadequately documented or did not appear to be related to the social service program purposes of CGI's state-funded programs. Examples of such inadequately documented expenditures include \$2,010 in restaurant charges, \$4,711 in car rentals, and \$13,978 in hotel charges. According to state regulations, expenses such as these that are inadequately documented or not directly related to the state-funded program activities of service providers are nonreimbursable under state contracts, and therefore CGI should return this \$75,197 to the Commonwealth.

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We found that, contrary to state regulations and the terms and conditions of its state contracts, CGI had not established adequate controls over the allocation of payroll expenses for its salaried employees. Specifically, although CGI had policies and procedures relative to the preparation and maintenance of payroll records, including weekly timesheets for its hourly (direct care) employees, these policies and procedures did not require CGI's salaried employees to complete weekly records documenting the hours worked and the functions benefited (e.g., specific program, cost center). As a result, there is inadequate assurance that all of the approximately \$1,767,768 in salaries and related costs that CGI allocated against its state contracts for its salaried employees during our audit period was accurate.

7. UNALLOWABLE SALARY RESERVE EXPENSES TOTALING \$38,484 **40**

We found that, contrary to the terms and conditions of its state contracts, CGI failed to use \$38,484 in state funds that was supposed to be used to provide temporary salary increases to its lowest-paid direct care staff members for this purpose. Rather, CGI used these funds to finance other operational activities. As a result, CGI should reimburse the Commonwealth \$38,484.

8. INADEQUATE ADMINISTRATIVE AND INTERNAL CONTROLS OVER CERTAIN AGENCY OPERATIONS **43**

We found that CGI had not developed and implemented an adequate system of internal controls over various aspects of its operations. Specifically, we found that CGI did not properly document its accounting system, improperly accounted for inter-company transfers, did not maintain all of its records in accordance with state regulations, failed to establish an effective inventory system for its fixed assets, and did not establish proper security over access to its computer-based accounting records. As a result, the Commonwealth cannot be assured that public funds were properly safeguarded against misuse and expended for their intended purposes, or that all of CGI's transactions were properly authorized, recorded, and reported.

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INTRODUCTION

Background

Community Group, Inc., (CGI) was organized in Massachusetts on April 21, 1972 as a wholly owned for-profit subsidiary of a publicly held organization, First Community, Inc., (FCI)¹. CGI provides operational, residential, individual support, and training services for developmentally disabled individuals in several residential facilities throughout eastern Massachusetts and a sheltered training center located in Wakefield. CGI receives funding primarily from the state's Department of Mental Retardation (DMR) and its clients, as indicated in the table below:

Community Group, Inc.

Summary of Revenue *

October 1, 1996 through September 30, 2001

Revenue Source	Fiscal Year**			
	1998	1999	2000	2001
Department of Mental Retardation (DMR)	\$3,616,035	\$4,168,090	\$4,120,174	\$3,367,083
Client Resources (SSI, food stamps, etc.)	<u>267,406</u>	<u>-</u>	<u>295,349</u>	<u>292,356</u>
Total Revenue	<u>\$3,883,441</u>	<u>\$4,168,090</u>	<u>\$4,415,523</u>	<u>\$3,659,439</u>

* Information was obtained from CGI's financial statements and does not include revenue CGI received from non-state sources in its Community Training Center Program. (See Audit Result No. 1a.)

** During fiscal years 1997 through 2000, CGI's fiscal year was October 1st through September 30th. Beginning in fiscal year 2001, CGI adopted the state's fiscal year period, which is July 1st through June 30th.

During our audit period, CGI conducted transactions with two related-party organizations and disclosed these transactions in the Uniform Financial Statements and Independent Auditor Reports (UFRs) that it filed with the state's Operational Services Division (OSD) for fiscal years 1997 through 2000. These related parties include FCI and CGI's Executive Director. A description of these related parties follows:

¹ FCI was originally organized in March 1968 as Mutual Franchise Corporation in the state of Delaware. In 1988 the agency changed its name to First Mutual Inc., and in March 2001 changed its name to FCI. During the period of our audit, FCI remained a foreign corporation (not organized in Massachusetts).

- FCI: CGI is a wholly owned for-profit subsidiary of FCI. (See Footnote 1.) CGI's Executive Director is also the President and principal stockholder of FCI.
- CGI's Executive Director: During fiscal years 1997 through 2000, CGI leased three properties located in Wakefield and Lynn that were owned by CGI's Executive Director. In addition, CGI's Executive Director received compensation from CGI for management services he purportedly provided to the agency on behalf of FCI and himself. (See Audit Results No. 1a. and No. 4.)

During our audit, we reviewed the UFRs that CGI submitted to OSD for fiscal years 1997 through 2000 and identified at least three other related-party transactions/affiliations that were not disclosed in CGI's financial statements, contrary to OSD regulations and guidelines. (See Audit Result No. 1 b.)

Subsequent to the end of our audit fieldwork, DMR officials notified the Office of the State Auditor (OSA) that it had become aware of certain questionable transactions being conducted by CGI officials. As a result, DMR notified CGI that DMR would terminate all of its contracts with CGI effective December 21, 2002. In addition, DMR officials also stated that they have referred these matters to the Massachusetts Office of the Attorney General. Also, subsequent to the end of our audit fieldwork, CGI had turnover in key management positions. (See Subsequent Events section.) As a result, all references in this report to CGI's Executive Director refer to the Executive Director who was in this position through the end of our audit period.

Audit Scope, Objectives, and Methodology

The scope of our audit was to examine various administrative and operational activities of CGI during the period October 1, 1996 to September 30, 2001. 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 applicable 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 CGI had implemented effective management 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 CGI'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 management controls established and implemented by CGI 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 CGI's accounting system. We used this assessment in planning and performing our audit tests. We then held discussions with CGI officials, members of the agency's Board of Directors, and OSD officials and reviewed organization charts and internal policies and procedures as well as all applicable laws, rules, and regulations. We also examined CGI's financial statements, budgets, cost reports, 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. Finally, we reviewed various documents that were provided to us by CGI officials relative to certain activities conducted by CGI's related-party organizations.

Our audit was limited to a review of the activities of CGI. Although we reviewed various documents relative to certain activities conducted by CGI's related parties, we did not conduct any audit work at these entities. Our audit was not conducted for the purposes of forming an opinion on CGI's financial statements. We also did not assess the quality and appropriateness of all program services provided by CGI under its state-funded contracts. Rather, our report was intended to report findings and conclusions on the extent of CGI's compliance with applicable laws, regulations, and contractual agreements; to determine the adequacy of CGI's performance;

and to identify services, processes, methods, and internal controls that could be made more efficient and effective.

AUDIT RESULTS

1. HIGHLY QUESTIONABLE RELATED-PARTY TRANSACTIONS TOTALING \$1,121,964 AND UNDISCLOSED RELATED-PARTY TRANSACTIONS TOTALING HUNDREDS OF THOUSANDS OF DOLLARS

During our audit period, Community Group, Inc., (CGI) inappropriately transferred at least \$1,121,964 in commercial income that it realized in its state-funded Community Training Center Program (CTCP) to CGI's Executive Director and related organizations owned by the Executive Director. According to state contracting requirements, CGI is required to identify any non-state revenues, including commercial income it received in this program, as being available to offset the cost the state was paying to operate the program. However, we found that CGI did not report any of the \$1,121,964 in commercial income that it received in this program as program revenue in the financial statements it filed with the Commonwealth and did not use any of this commercial income to defray the state's cost of operating this program. Rather, these funds were transferred to non-CGI accounts and used by CGI's Executive Director to pay for personal expenses such as \$210,027 in mortgage costs related to private business ventures; \$74,370 in lease costs for a Mercedes Benz; \$103,920 for dues, restaurant charges, and other expenses at a country club; \$5,500 for laser eye surgery; \$15,331 for flowers; and \$80,993 in landscaping fees, \$26,654 in electrical service fees, and \$21,156 in home heating oil charges for the Executive Director's personal residence. We also found that, contrary to state regulations, CGI failed to disclose in the financial statements that it filed with the state at least three other related-party transactions involving hundreds of thousands of dollars. As a result, state funding and oversight agencies did not have the ability to adequately assess CGI's activities and performance and were overcharged by as much as \$1,121,964. A description of the problems we identified appear in sections a and b, below:

a. Highly Questionable Related-Party Transactions Totaling \$1,121,964

When negotiating contracts with state agencies, human services providers such as CGI are required to accurately identify any other sources of revenue that are going to be available to the state-funded program. Providers are required to use these additional revenues to offset the costs the state will have to pay to operate the program. For example, if a program is

budgeted to cost \$100,000 to operate and the provider anticipates collecting \$10,000 in client fees for the program, the provider can request only \$90,000 (\$100,000 - \$10,000 in offsets) from the state agency as funding for the program. In the case of commercial income, which is the difference between gross revenues and gross expenses derived by a provider from the sale of products and services by consumers in the program, providers are required to disclose these revenues in their financial statements so that state purchasing agencies can determine if they want to use any or all of this commercial income as offsets to the state's cost of operating the program.

The state's Operational Services Division (OSD), the agency responsible for regulating the activities of contracted human services providers such as CGI, describes offsetting revenue in 808 Code of Massachusetts Regulations (CMR) 1.02, as follows:

Off-Setting Revenue. The sum of the following revenues and support items. These revenues and support items must be received during the price year and must be dedicated for use in the same Program that also receives Commonwealth funds.

- (a) any Contractor revenues and support (including but not limited to public and private grants, gifts, contributions, bequests, or any income therefrom, income from endowments, funds received from the Massachusetts Department of Education's Bureau of Nutrition, or similar funding) to the extent that revenues and support are restricted to use in the Program;*
- (b) the amount of unrestricted revenues and support voluntarily designated by the Contractor to defray the cost of Program services to a Department;*
- (c) the fair market value of any public employees assigned to work in the Contractor's Program (including salaries, fringe benefits and travel allowances) and/or the occupancy of public facilities to the extent that they are available to the Program without charge or at less than fair market value;*
- (d) any revenues and support (including but not limited to Supplemental Social Security Income, Food Stamps, Emergency Aid to the Elderly, Disabled and Children (EAEDC), reimbursements from third-party payers, Client sliding fee scale payments) received by or available to the Contractor on account of Clients;*
- (e) the amount of Commercial Income that the Contractor or Department may designate;*
- (f) the value of revenues and support used to defray non-reimbursable costs; and*

(g) not-for-profit Contractor surplus revenue retention funds accrued in excess of the limitations of 808 CMR 1.03(7) which may be utilized at the discretion of the Department to reduce the Authorized Price or Maximum Obligation of the Commonwealth.

During fiscal years 1997 through 2001, CGI entered into a contract with DMR, with an average annual maximum obligation of \$411,477, to operate its CTCP in Wakefield. The table below summarizes the funding DMR provided CGI for this program during this period.

**CGI
Summary of Reimbursements in the Community Training Center Program
Fiscal Years 1997-2001**

Fiscal Year	Annual Reimbursements
1997	\$ 423,065
1998	417,379
1999	441,872
2000	423,845
2001	<u>351,223</u>
	<u>\$2,057,384</u>

Under the terms and conditions of its contract with DMR, CGI was to operate a CTCP to provide job placement services to a diverse group of developmentally disabled individuals. In this program, CGI was to provide DMR clients with basic work skills and a safe and supervised work environment with the goal of eventually transitioning these clients to an outside job placement within a work setting in the community.

In addition to the revenues CGI received under its state contracts, CGI also received commercial income from at least five other private companies to provide services in this program. These services included having DMR clients in this program assemble screw packets, bird feeders, sewing kits, and other items for which CGI was paid by these private companies a set amount for each item assembled. We found, however, that although CGI received this commercial income as a result of the work performed in its CTCP, it never disclosed this income as being available to offset the state's cost of operating this program and did not record and report this income as being earned in this program either in its own

financial records or in the Uniform Financial Statement and Independent Auditor's Reports (UFRs) it filed with OSD. Rather, all of the commercial income generated in this program, which totaled \$1,121,964, was subsequently transferred by CGI into one of three accounts that were in the name of one of three related parties: Community Group Training Center Inc. (CGTC), FCI, or the agency's Executive Director. The table below summarizes the amount of funds transferred to these three accounts during our audit period.

**Community Group, Inc.
Allocation of Community Training Center Program Commercial Income
Fiscal Years 1997 through 2000**

CGI Account	Balance**	Fiscal Year				Totals*
		1997	1998	1999	2000	
CGTC	\$263,822*	\$104,585*	\$271,100*	-	-	<u>\$ 639,507*</u>
Executive Director	N/A	-	-	\$ 84,148	-	<u>\$ 84,148</u>
FCI	N/A	\$169,817	-	\$799,059	\$68,940	<u>1,037,816</u>
Total						<u>\$1,121,964***</u>

* The amounts indicated in the CGTC account were maintained by CGI in its accounting records as an accounts payable to the workshop program (CGTC). These amounts were subsequently transferred to the FCI account. Therefore, the total amount only includes the totals from the Executive Director's account and the FCI account.

** This 1996 figure represents the opening balance of this account, which was purportedly the result of profits generated in CGI's Community Training Center Program during fiscal years 1995 and 1996.

*** This figure includes the commercial income realized in the program, all interest earned on undistributed funds, and miscellaneous adjustments to the CGTC account.

Our review of the transfers of these funds to these accounts identified a number of problems. First, the \$639,507 that CGI recorded as an accounts payable to CGTC during the period of our review appears to be inappropriate. Specifically, according to CGI officials, CGTC has no staff or physical office space and did not directly provide any services in CGI's CTCP. These assertions made by CGI's staff are supported by the fact that the Public Charities (PC) reports filed by CGTC with the Massachusetts Office of the Attorney General during the audit period indicated that CGTC has only one employee, CGI's Executive Director. These PC reports also identified CGTC as having the same corporate address as CGI's administrative offices.

We also found that CGI did not enter into any written contracts with CGTC that provided for CGTC to receive any commercial income generated in this program. Rather, state-funded staff provided all of the services in this program, including the solicitation of contracts with private firms for program services. In fact, regarding the solicitation of contracts with private firms, we determined that CGI paid several members of its own staff thousands of dollars, in addition to their regular salaries, as bonuses for obtaining these contracts. The Commonwealth also paid for all other costs associated with the operation of this program, including rent, utilities, and other overhead expenses. Similarly, CGI could not provide us with any documentation to substantiate the reason for its transferring \$84,148 directly to CGI's Executive Director's account or \$1,037,816 to the FCI account. Subsequent to CGI's transferring this \$1,121,964 to these accounts, these funds were periodically withdrawn from these accounts by CGI's Executive Director, either by making direct withdrawals or having FCI use funds transferred to these accounts to pay his personal expenses.

According to CGI's Executive Director, he was entitled to the commercial income because he had provided management services to CGTC, CGI, and FCI. However, the Executive Director could not substantiate this assertion with any documentation (e.g., signed contracts, invoices) showing dates and a description of the management services he claims to have provided. Moreover, given that he is the administrative head of all three organizations, we question what additional management services the Executive Director could have provided that were not already part of his job-related responsibilities as chief administrator of these organizations.

Clearly, since CGI used state resources to provide all the services to private organizations in this program, the \$1,121,964 in commercial income that it received from these private sources should have been disclosed to DMR so it could have been used to offset all or a portion of the state's costs of operating this program. However, rather than disclosing these funds as being available to offset the state's costs as required by its contract, CGI's Executive Director used these funds to pay for a variety of personal expenses, including the following:

- Loan Payments:** During our audit period, FCI used at least \$210,027 in funds that were transferred to it by CGI to make loan principal and interest payments to the Bank of Newport (BON) on behalf of CGI's Executive Director. CGI's Executive Director stated that in the "late eighties" FCI secured a loan with BON that he said was necessary to pay the Internal Revenue Service (IRS) for overdue employee withholding taxes, including penalties and interest, owed by CGI. He stated that this tax arrearage was due to a defalcation by CGI's former Chief Financial Officer (CFO), totaling over \$500,000 during the late 1980's, which limited the amount of funds CGI had to pay these tax liabilities. The Executive Director stated that although the former CFO was convicted of the theft, restitution was never ordered and CGI only recovered approximately \$80,000 from its corporate insurance policy. On several occasions, we requested from CGI officials supporting documentation (e.g., police reports, correspondence from the IRS and CGI's insurance company), relative to this purported incident. However, CGI officials were not able to provide us with any documentation to substantiate the Executive Director's assertions. Consequently, the audit team met with BON officials to review the bank records relative to these loans and to identify the scope and purpose of these loans. Based on our audit work in this area, we found that, contrary to what CGI's Executive Director told us, the \$400,000 loan was not only used to pay for outstanding tax liabilities for CGI but was also substantially used to make a payment for the Executive Director's \$55,000 personal tax liability and a \$81,902 tax liability of an FCI affiliate, BWS International LTD., as follows:

CGI

Summary of the Use of the Funds from the \$400,000 Loan

Entity	DOR	IRS	Totals*
CGI	\$81,685	\$200,000	\$281,685
FCI Affiliate	\$81,902	N/A	81,902
Executive Director	\$55,000	N/A	<u>55,000</u>
			<u>\$418,587</u>

* These amounts exceed the \$400,000 loan amount because other funds, in addition to the \$400,000 loan in question, were used by CGI's Executive Director to pay these obligations.

Our review of the records at BON also identified that these \$210,027 in payments were also used to make payments on a second loan of \$680,000. The proceeds from this loan were used to consolidate notes with original obligations totaling \$800,000, as follows:

1. An unsecured note dated January 28, 1983 from Mutual Enterprises, Inc., (also known as FCI) to BON in the amount of \$200,000.

2. A note dated February 1, 1984 from BSDJ Dallas Inc. to BON in the amount of \$300,000 (the purpose of the loan was for opening and set-up costs of a clothing store in Copley Place, Boston, purportedly by the wife of CGI's Executive Director).
3. A note dated February 1, 1984 from BWS International, LTD. to BON in the amount of \$300,000 (the purpose of the loan was for opening and set-up costs for a clothing store in Dallas, Texas, purportedly by the wife of CGI's Executive Director).

More significant than the questionable use of these funds used to pay these notes was the fact that, when this \$680,000 note was refinanced in 1987, CGI was made a co-borrower on the note although it had not incurred any of the liabilities or received any of the proceeds from these loans.

- FCI paid at least \$106,007 in American Express credit card charges incurred by CGI's Executive Director during the audit period that appear to be for personal expenses, some of which are as follows:
 1. Expenses totaling \$15,331 for flowers, including 11 purchases totaling \$15,198 from Winston Flowers in Boston.
 2. Expenses totaling \$14,639 for gifts, including \$2,249 in purchases at Giorgio Armani clothing stores (in Manchester, Vermont; Central Valley, New York; and Palm Beach, Florida); a \$2,286 expense for the purchase of shoes at Giorgio's of Palm Beach; a \$893 purchase at the Cartier Boutique in Boston; and a \$5,000 contribution to the Combined Jewish Philanthropies.
 3. An expense totaling \$5,500 to a Manhattan optometrist for fees associated with laser eye surgery in New York City.
 4. Expenses totaling \$9,152 in hotel charges for hotels in Vermont, New York City, Washington D.C., Boston, Marina Del Ray, Kennebunkport, and Paris.
 5. Expenses totaling \$15,464 in restaurant charges in New York City, Vermont, and Boston area restaurants such as \$1,392 at Mistral, \$798 at Pravda 116, \$434 at the Federalist, and \$928 at the Capital Grille.
 6. Automobile expenses totaling \$10,281, including \$8,926 for repairs and service to the Executive Director's Mercedes Benz automobile.
 7. Telephone expenses totaling \$11,798 incurred by CGI's Executive Director, and \$1,474 for Internet service at the home of the Executive Director.
 8. Expenses totaling \$13,677 for miscellaneous items such as a \$2,000 donation to the Museum of Fine Arts, \$422 for a sports center charge in a Stratton Mountain

resort in Vermont; \$565 for a club membership in Fit America; \$370 for dry cleaning; and \$211 at Gourmet Liquors in Framingham, Ma.

- We also found many other personal expenses of CGI's Executive Director that were paid for with these funds during our audit period, including the following:
 1. Expenses totaling at least \$103,920 in dues, restaurant, and other charges at the Belmont Country Club.
 2. Expenses totaling \$74,370 for leasing a Mercedes Benz for CGI's Executive Director.
 3. Expenses of \$80,993 for landscaping fees; \$26,654 for electrical services, and \$21,156 for home heating oil costs at the private home of CGI's Executive Director.
 4. Expenses totaling \$22,216 in life insurance costs for CGI's Executive Director during the audit period.
 5. Expenses totaling \$17,511 in telephone costs associated with telephone service at CGI's Executive Director's private residences and his cell phones.
 6. Jewelry expenses totaling \$7,061 during the audit period purportedly for gifts for employees (CGI could not provide us with any documentation to substantiate that the funds were used for this purpose).
 7. A May 9, 2000 payment of \$4,083 from FCI to Homecomings Financial Network for a mortgage on a private residence in Vermont owned by CGI's Executive Director.

Regarding these matters, CGI's Executive Director stated that he formed CGTC many years ago with the purpose of generating commercial income for CGI's CTCP, which he indicated operated at a loss for many years and only became profitable when it started to solicit work from outside vendors and with the assistance of CGTC. He also stated that his attorney advised him that he could legitimately move the commercial income from CGI to CGTC and FCI, and then assess FCI and CGTC for management fees for administrative services in an amount equal to the annual commercial income of the program. However, for the reasons previously cited, CGTC was clearly not entitled to receive any of the commercial income received in CGI's CTCP. Regarding the use of commercial income generated in the CTCP to pay the personal expenses of CGI's Executive Director, the agency's legal counsel stated that, in the Executive Director's opinion, any commercial income generated in this

program could be used by him in any manner he deemed appropriate and that none of these funds should be subject to recovery by the Commonwealth. However, clearly since CGI billed the Commonwealth for the entire costs of operating this program, any commercial income generated in this program should have been disclosed to DMR so it could have been used to defray all or a portion of the state's costs.

b. Undisclosed Related-Party Relationships and Transactions Totaling Hundreds of Thousands of Dollars

OSD has promulgated regulations relative to related-party transactions. Specifically, OSD defines a related-party in 808 CMR 1.02 as:

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).

FASB 57 defines a related party in part, as follows:

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. . . .

Examples of related-party transactions include transactions between (a) a parent company and its subsidiaries; (b) subsidiaries of a common parent; Transactions between related parties are considered to be related-party transactions even though they may not be given accounting recognition. For example, an enterprise may recover services from a related party without charge and not record receipt of the services.

In addition to promulgating regulations, OSD has published various documents that provide guidance to human services organizations such as CGI and their private accounting firms on how to assess an entity's compliance with applicable laws and regulations. Regarding the disclosure of related-party relationships, the UFR Auditor's Compliance Supplement under 808 CMR 1.00, which is published by OSD and was in effect during the audit period, states, in part:

All material related-party transactions that are not associated with programs purchased by the Commonwealth or that could affect the provider's financial statements and all instances of common ownership or management control

relationships for which 808 CMR 1.02 and the AICPA Statement of Financial Accounting Standards No. 57 (SFAS No. 57) require disclosure, even though there are no transactions, should be disclosed in the UFR notes to the financial statements....

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

If, after a hearing, DPS [now OSD] finds a violation of 808 CMR 1.04(4), 1.04(5) or 1.05, DPS may order that the contract(s) directly affected by such violation be terminated or may assess a civil penalty of not more than \$2,000 or 10% of the Contractor's annual Maximum Obligation under such contract(s), whichever is greater. If DPS determines after a hearing that a Contractor has committed repeated willful violations of 808 CMR 1.04(4), 1.04(5) or 1.05, DPS may debar the Contractor for a period not to exceed five years.

During our audit, we reviewed the UFRs submitted by CGI to OSD for fiscal years 1997 through 2000 and found that the following related-party relationships and transactions were not disclosed by CGI as required by OSD regulations:

- Community Group Training Center, Inc. (CGTC): This entity was established as a nonprofit 501(c)3 unincorporated subsidiary of FCI on October 1, 1994. According to its corporate bylaws, CGTC's primary mission is "to provide a stable and secure work environment for challenged individuals who would otherwise not be able to find gainful employment in the general work force. CGTC acts as a not-for-profit organization accumulating its excess of revenue over expenses, and upon dissolution will transfer all of its assets and rights to another charitable organization that is a recognized charity by IRS code 501(c)3." According to CGTC's corporate bylaws, the Executive Director of CGI is also the President of CGTC, and the Assistant Executive Director of CGI is also the Secretary/Treasurer of CGTC. During our audit period, CGI transferred \$639,507 in funds from this organization. (See Audit Result No. 1. a.) Therefore, this related-party relationship and transactions should have been disclosed in CGI's UFRs as required by OSD regulations.
- Green Oaks Realty Trust (GORT): During the audit period CGI leased property from this realty trust, which is a partnership in which CGI's Executive Director owned a 67% interest. This realty trust consisted of four apartments located in Wakefield, of which two were leased to CGI during the audit period. According to the agency's financial records, during fiscal years 1997 through 2001, CGI paid GORT a total of \$119,940 in lease payments. This property was sold in December 2001 for approximately \$475,000. Therefore, the related-party relationship and

transactions should have been disclosed in CGI's UFRs as required by OSD regulations.

- Front Street Realty Trust (FSRT): CGI leased property from FSRT during the audit period. According to CGI's Executive Director, he had a partnership agreement relative to the ownership of this property that stipulated that he was to receive a 50% share of the profit from the sale of the property. According to CGI's financial records, during fiscal years 1997 through 2001, CGI paid FSRT a total of \$85,200 in lease payments. The property was sold during the audit period and resulted in a net gain of \$44,000 for CGI's Executive Director. Therefore, this related-party relationship and transactions should have been disclosed in CGI's UFRs as required by OSD regulations.

Regarding these matters, agency officials did not comment on why these related-party relationships and transactions were not disclosed in its UFRs.

Recommendation

In order to address our concerns relative to this matter, we recommend that CGI's principal state purchasing agency (DMR), in conjunction with OSD, recover from CGI as much of the \$1,121,964 in undisclosed commercial income that CGI realized in its CTCP as it deems appropriate. Further, CGI should amend its UFRs for fiscal years 1997 through 2000 to accurately disclose all of its related-party transactions and relationships. Should CGI continue to enter into contracts with state agencies, it should take measures to ensure that it fully discloses all related-party relationships and transactions in its financial statements and disclosures as required by GAAP and state regulations.

Auditee's Response

In response to this audit result, CGI's President provided the following comments:

This finding combines two issues; the related party disclosure and income from commercial activities. On the matters regarding related parties, the related parties were identified and disclosed in the notes to the financial statements on all the years audited. It may be possible, however, that the amounts from the commercial income were not properly reported on the financial statements, which were prepared by independent auditors. Both of the independent auditors who prepared the financial statements for CGI and CGTC reported the commercial income in CGTC, however, if it would be more appropriate for these funds to be reported in the financial statements for CGI then we will file corrected financial statements. . . .

Later in the document the regulation definition for off-setting revenue is included, one line of which reads, "the amount of Commercial Income that the Contractor or Department may designate" (emphasis added). Contrary to the description by the Auditor, the regulation allows, but does not require, that commercial income to defray the cost to the state. Our understanding is that if, and only if, CGI had prospectively included an amount of commercial income in the contract when signed, then those funds would have been available to defray the state cost. It may be worth noting that this same workshop has experienced losses in the years within and outside of the audited period. In particular, revenue declined from 1999 forward after a major customer took assembly work to Mexico to cut costs.

Outside of what is contained in the contract documents, clarifying information can also be gained by looking at the end of year reporting requirements. The regulations require that other public revenues, which are received for support of the program, must defray the cost to the state. Commercial income is not public revenue, nor is it received for the support of the program. It is defined in the same set of regulations, 808 CMR 1.02; "The difference between gross revenues and gross expenses resulting from the production of commercial products and services by Clients."

It would seem clear that the regulations make a deliberate distinction between funds that are received for the support of the program, whether state or other public revenues (e.g., Medicare), and funds that are received in exchange for products or services provided to outside entities. Our understanding is that commercial income is not required to be applied to reduce the cost to the state specifically because the funds are not paid in order to support the program, they are paid in exchange for products or services. Our review and consultation with other workshops, auditors and state agencies is that this is the standard interpretation. The Office of the State Auditor appears not to make any distinction between these two, and uses the terms interchangeably. [The report] states, "CGI also received revenues from at least five other private companies to provide services," then two sentences later states that CGI "never disclosed this program revenue as offsets to the state's cost." Commercial fees are paid for commercial services, not to support the program.

As a technical matter, the simple reporting of commercial revenue does not automatically produce an offset. Projected offset amounts are included in the state contracts, but end-of-year reporting does not suddenly produce a contract offset. Contrary to the Auditor's assertion that CGI "never disclosed this program revenue as offsets to the state's cost," it is impossible to disclose revenue as an offset in financial statements except in cost reimbursement programs. In all other cases offsets are only possible through being included in the contract documents themselves, not through the financial statements. The use of commercial income as an offset requires agreement by both parties, and therefore can only be included in the contract which is executed between the state and the vendor. Through examining the contracts and financial statements of other agencies with workshops, we have seen that even when a workshop contract included a projected offset, if the workshop exceeded that amount it was not required to return the difference to the state. In fact, the adoption of a policy requiring that every dollar of commercial work be turned over to the state would diminish the motivation for any workshop to seek gainful commercial activity.

Additional support for our position on this matter can be gained by examining the UFR reporting template, which automatically calculates the surplus state revenue. The line for commercial activity (line 45R in the fiscal year 2002 UFR schedule A) is backed out of the calculation, so that it has no effect regarding the total revenues available to support the state's portion of the program. Therefore, even if the amount had been included in the financial statement for CGI instead of CGTC, it does not appear that it would have any net effect regarding reducing the state's cost.

We would also call into question the manner in which the Auditor has chosen to represent this issue, in that the issue of commercial income is based on commercial income retained, not on the gross revenues. . . . It is our position that this figure represents gross non-state revenues for the audit period, and that profits were substantially less. As stated previously, independent auditors prepared the state filings for Community Group and the CG Training Center, and if the commercial income needs to be reported differently then these reports will be re-filed as necessary. It is important to note, however, that based on an examination of the applicable regulations, along with an examination of workshops operated by other agencies, it would not appear that corrected filings would cause the net commercial income to become subject to recoupment by the state.

Auditor's Reply

Contrary to what CGI asserts in its response, the agency did not adequately report all its related-party relationships and transactions during fiscal years 1997 through 2000. Specifically, as stated in our report, during our audit period, we found at least three instances in which CGI failed to fully disclose related-party transactions and relationships as required by OSD guidelines. By not disclosing these related-party relationships and transactions in its UFRs, CGI failed to properly provide the Commonwealth and other users of this information with all of the information necessary to assess the propriety and reasonableness of these related-party activities.

In its response, CGI states that it may be possible that the firm's independent auditors who prepared the agency's financial statements did not properly report the commercial income in question. However, for CGI to assert that its accounting firm is solely responsible for the agency's failure to report these revenues in its financial statements is unfounded. According to Generally Accepted Accounting Principles (GAAP), with which CGI is required to comply, it is clearly management's and not the auditor's responsibility to maintain accurate and complete financial records and to generate accurate and complete financial reports. By not reporting this revenue, CGI was not in compliance with applicable state regulations 808

CMR 1.00 and the terms and conditions of its state contracts, which require the agency to maintain its records in accordance with GAAP. These instances of noncompliance could not only jeopardize CGI's state funding but could result in CGI being assessed significant civil penalties.

Of particular concern is the fact that we found that each time CGI received payments from a private company for work performed in its CTCP, the agency would record it as revenue in an account (No. 4500) entitled, "Outside Vendor Income." CGI's CFO told us that, subsequent to these funds being recorded in this account, the costs incurred by CGI for client payroll and the cost of goods sold were removed from this account and the remaining commercial income was transferred into one of three accounts: the Training Center (CGTC) Account No. 2001, the Due to Stockholder (CGI's President) Account No. 2325, or Due to First Mutual Inc. (FCI) Account No. 2610. As detailed in our report, the funds in these three accounts were subsequently transferred to FCI. Since these revenues were generated in the CTCP, GAAP requires that these revenues be reported by CGI as CTCP revenue. Because CGI did not account for these revenues in this manner, it not only failed to comply with applicable state regulations and the terms and conditions of its state contracts to maintain its records in accordance with GAAP, but also lost the ability to ensure that the receipt of these funds by CGI's President were accurately reported by this individual to the appropriate taxing authorities. Specifically, as noted in our report, CGI did not distribute all of these profits directly to CGI's President. Rather, we found that CGI would periodically transfer funds to FCI, which in turn would pay for various personal expenses of CGI's President. Since these expenses were personal in nature, any expenses paid on behalf of CGI's President should have been reported by him as income on his tax returns. However, because CGI handled these funds in this manner, it lost its ability to be able to disclose funds used to pay for these personal expenses as taxable income on the President's IRS W2 Forms. During our audit, we requested CGI to provide us with copies of the IRS W2 Forms that were issued to CGI's President by FCI and CGI during our audit period. These Form W2s did not appear to identify as taxable income the cost of any of the personal expenses FCI paid on behalf of the President during our audit period.

Of equal concern is the fact that not only were these revenues not reported as being received by CGI but also that they appear to have been reported as being received by one of CGI's related parties, CGTC. Specifically, for fiscal years 1997 through 2000, CGTC's annual financial statements, its Form PCs and its IRS Form 990s, which are reports all nonprofit organizations are required to file annually with the Public Charities Division of the State Attorney General's Office, disclosed CGTC's revenue and related expenses as follows:

CGTC

Summary of Financial Information Reported*

Fiscal Year	Revenue	Materials	Labor	Operating Expenses
1997	\$293,081	\$59,774	\$63,490	\$135,000
1998	382,065	47,854	79,830	231,337
1999	369,005	61,920	62,921	250,000
2000	<u>207,180</u>	<u>59,299</u>	<u>78,942</u>	<u>150,000</u>
Total	<u>\$1,252,331</u>	<u>\$228,847</u>	<u>\$285,183</u>	<u>\$766,337</u>

* Information was extracted from CGTC's Form PCs. The column entitled "Operating Expenses" represent funds that were transferred to FCI as a management fee.

Since CGI and not CGTC operated this program, the revenue and expense amounts reported by CGTC in these reports is questionable.

Contrary to what CGI states in its response, we did not state or even imply that the reporting of commercial income will automatically produce a contract offset. Rather, our report correctly states that, in accordance with state regulations and the terms and conditions of its state contracts, CGI was required to accurately report these receipt of this commercial income in its financial statements. While the reporting of this commercial income would not have automatically produced a contract offset, it would have provided CGI's principal state funding agency, DMR, with the required information necessary to determine whether any of this income should have been used to offset the state's costs of operating this program. We did not state that the Commonwealth has adopted a policy whereby human service providers need to turn over every dollar of commercial income to the state. We merely state that CGI was obligated to disclose the amounts of commercial income it was receiving in this program

to DMR so that DMR had the opportunity to utilize some or all of this revenue as offsets. Given the millions of dollars in profits that CGI realized under its state contracts during our audit period, and the fact that the agency is in the business of serving needy individuals, we believe that it would have been proper and reasonable for CGI to include some if not all of the commercial income it received in this program as offsets to the state's cost of operating this program so that more funds would be available to the state to serve needy individuals.

We do not agree with CGI that the use of commercial income as an offset requires agreement by both parties. As stated in our report, state regulations allow either [emphasis added] the provider or the state-purchasing agency to designate any commercial income as offsets to the state's cost of operating program. However, our concern is that CGI used facilities and staff paid for by the Commonwealth in its CTCP to generate significant commercial income, did not appropriately disclose this fact to its state purchasing agency, and accounted for this commercial income in a questionable manner. Clearly, since the state paid the costs of the operation of this program, CGI should have made the Commonwealth aware of the commercial income that was being generated in this program so that at least some of this income could be used to defray the state's costs. If CGI had done this, more state funds would have been available to serve additional needy consumers.

Finally, in addition to the problems we identified relative to CGI's handling of non-state revenue in its CTCP, during the course of our audit, CGI officials also told us that they were paying the DMR consumers working in this program less than the prevailing minimum wage. This policy, if true, could be a violation of federal regulation 29 CFR 525, Section 14(c) of the Fair Labor Standards Act (FSLA) and state regulations 455 CMR 2.03(7). According to CGI's Assistant Executive Director, the agency believed it could pay the consumers working in this program below the prevailing minimum wage based upon the volume and level of their work. CGI's President told us that the CGTC was organized as an unincorporated nonprofit agency so that the prevailing minimum wage requirement for the work performed by state consumers would be waived. However, according to provisions of FSLA and the aforementioned state regulations, sheltered workshops such as CTCP are required to apply for a certificate from the Wage and Hour Division of the United States

Department of Labor (DOL) to pay special minimum wages (wages less than the federal minimum wage) to disabled workers for the work being performed. According to these regulatory pronouncements, without a current certificate, employers must pay disabled workers at least the prevailing minimum wage for all work performed regardless of the productivity of their work. We contacted both federal and state officials relative to this issue, and they informed us that CGI had not applied for a federal or state certificate to pay special minimum wages to state consumers working in the CTCP during or subsequent to the period covered by our audit. Consequently, we are referring this matter to the respective oversight agencies, including the Wage and Hour Division of the United States Department of Labor and the Division of Occupational Safety of the Massachusetts Department Labor and Workforce Development, for their review and resolution.

2. UNALLOWABLE PROFITS TOTALING AS MUCH AS \$463,058 CHARGED AGAINST STATE CONTRACTS

According to state regulations, for-profit contracted service providers such as CGI are required to negotiate the amount of profits they can make on state contracts. We found, however, that in addition to the commercial income CGI retained in its CTCP, during our audit period CGI retained as much as an additional \$463,058 in profits in excess of what was allowed by its state contracts in its other state funded programs. As a result, CGI owes \$463,058 in excessive and unallowable profits to the Commonwealth.

OSD has promulgated regulations and guidelines relative to the amount of profits for-profit organizations such as CGI can make under state contracts. In this regard, 808 CMR 1.03 (6) promulgated by OSD states:

Commercial Fee. Departments may prospectively negotiate an earnings allowance with for-profit Contractors, which is in excess of the costs for the services being procured. . . .

Additionally, OSD's Procurement Policies and Procedures Handbook establishes policies for limiting the amount of profit for-profit human services providers can earn from state contracts, by stating:

***For-Profit Earnings/Commercial Fee.** For-Profit contractors who provide human and social services to the Commonwealth may earn a commercial fee on their contracts. However, this fee must be negotiated and agreed upon by the department and the contractor at the time of procurement and contract execution, even if it is anticipated to be zero.*

***Commercial fees for for-profit contractors.** A number of human and social service contractors are organized on a for-profit basis. In order to avoid confusion and subsequent audit findings, departments must be explicit about the amount of profit, if any, which can be earned by a for-profit Contractor. . . . Departments, may consider several approaches in developing a commercial fee. . . .*

Our review of the contracts between CGI and DMR for fiscal years 1997 and 1998 identified that there were no provisions for CGI to receive a commercial fee in any of the contracts entered into between CGI and DMR during this period. Further, CGI could not provide us with any documentation to substantiate that commercial fees or profit levels had ever been negotiated and agreed to between CGI and DMR for these contracts. In the absence of an agreed-upon commercial fee, we used a 5% per contract commercial fee figure (DMR's standard commercial fee) to determine the potential excessive profits CGI realized under its contracts with DMR during these two fiscal years. Our review of CGI's UFR filings for fiscal years 1997 and 1998 identified that CGI had in fact, reported a total of \$228,428 in profits in certain programs above 5%, as follows:

**Community Group, Inc.
Calculation of Profits Above 5%
Fiscal Years 1997 and 1998**

Fiscal Year 1997	Program #2*	Program #3				Annual Totals	Multi-Year Total
Max. Obligation	\$1,273,264	\$476,474					
Allowable Profit**	\$63,663	\$23,824					
Total Revenue	\$1,448,471	\$518,314					
Total Expenses	\$1,321,666	\$457,836					
Actual Profit	\$126,805	\$60,478					
Profit Above 5%	\$63,142	\$36,654				<u>\$ 99,796</u>	
Fiscal Year 1998	Program #2	Program #3	Program #10	Program #11	Program #12		
Max. Obligation	\$1,342,507	\$497,571	\$193,896	\$54,846	\$63,872		
Allowable Profit	\$67,125	\$24,879	\$9,695	\$2,742	\$3,194		
Total Revenue	\$1,474,262	\$533,877	\$195,147	\$220,526	\$217,665		
Total Expenses	\$1,353,919	\$475,564	\$172,354	\$202,787	\$200,586		
Actual Profit	\$120,343	\$58,313	\$22,793	\$17,739	\$17,079		
Profit Above 5%	\$53,218	\$33,434	\$13,098	\$14,997	\$13,885	<u>\$128,632</u>	<u>\$228,428</u>

* These program numbers correspond to the numbers that appear in CGI's UFRs. The actual program names/locations appear in the Appendix to this report.

Beginning in fiscal year 1999, the following addendum was attached to DMR's contracts with CGI:

If the provider in this contract, through cost savings initiatives and/or efficiencies, makes a profit on the contract, the provider may retain the profit or portion of it up to (5%) of the contract's maximum obligation. The provider must return any excess of this amount to the Commonwealth. The for-profit earnings factor is 5% within the current maximum obligation. No additional funds will be allocated to the current contract for the purpose of the earning factor.

Our review of CGI's UFR filings for fiscal years 1999 and 2000 identified that even after DMR added the addendum specified above, CGI had reported profits totaling \$463,058 in excess of the allowable 5% per contract maximum obligation amount agreed to in several of its programs, as detailed in the table below:

Community Group, Inc.						
Unallowable Profit Calculations						
Fiscal Years 1999 through 2000						
Fiscal Year 1999	Program #10	Program #30	Program #51	Program #62	Annual Totals	Multi-Year Total
Max. Obligation	\$1,427,159	\$506,736	\$211,367	\$202,569		
Allowable Profit	\$71,358	\$25,337	\$10,568	\$10,128		
Total Revenue	\$1,537,362	\$539,667	\$231,936	\$203,845		
Total Expenses	\$1,192,248	\$474,606	\$213,796	\$185,814		
Actual Profit	\$345,114	\$65,061	\$18,140	\$18,031		
Unallowable Profit	\$273,756	\$39,724	\$7,572	\$7,903	<u>\$328,955</u>	
Fiscal Year 2000	Program #2	Program #3	Program #14			
Max. Obligation	\$1,212,111	\$485,318	\$166,248			
Allowable Profit	\$60,606	\$24,266	\$8,312			
Total Revenue	\$1,338,150	\$529,232	\$176,034			
Total Expenses	\$1,186,295	\$465,242	\$164,592			
Actual Profit	\$151,855	\$63,990	\$11,442			
Unallowable Profit*	\$91,249	\$39,724	\$3,130		<u>\$134,103</u>	
						<u>\$463,058</u>

* The allowable profit amount equals 5% of the maximum obligation of the contract.

During our audit, we brought this matter to the attention of DMR's Deputy Assistant Commissioner of the Office of Management and Finance. Subsequently, the Assistant Commissioner notified CGI in a letter dated September 18, 2001 that CGI must repay the Commonwealth a total of \$58,657 that DMR calculated that CGI owed for profits above the 5% earnings factor that CGI reported in its fiscal year 1999 UFR. However, we reviewed this document and determined that the \$58,657 reimbursement amount was miscalculated by DMR in that it used 5% of the aggregate amount of the maximum obligations on all of CGI's contracts, which is contrary to the addendum developed by DMR that clearly states "five percent (5%) of the contract's maximum obligation." Additionally, in its calculation DMR included revenue generated from sources other than the contract, which is contrary to DMR's contract addendum that states that the 5% is to be applied to each contract's maximum obligation.

Regarding this matter, CGI officials stated that they believed the total allowable profit amount should be calculated using the aggregate maximum obligation of all contracts and not on a contract-to-contract basis and that therefore our calculation of unallowable profits is erroneous. However, as previously noted, the contract addendum agreed to by both DMR and CGI clearly identifies that the allowable profit amounts are to be calculated on a contract-by-contract basis. Additionally, during our audit, OSD officials stated that the 5% allowable profit or commercial fee is actually calculated based on the maximum obligation of each contract individually and should not include any other revenues (e.g., client fees) that may be received by a program.

Recommendation

In order to address our concerns relative to these issues, we recommended that DMR retract the September 18, 2001 reimbursement request it sent to CGI and recover from CGI at least the \$463,058 in excessive profits retained by CGI from state contracts during fiscal years 1999 and 2000. On December 19 2002, DMR's Acting Assistant Commissioner of the Office for Management and Finance sent a letter to CGI's Acting Executive Director in which the Acting Commissioner stated, in part:

It appears Community Group Inc. failed to identify \$1,121,964 in non-state revenues realized from the DMR funded Community Training Center. [Audit Result No. 1] These revenues should have been reported to offset the cost DMR paid to fund the program. As a result of this reporting omission the profits that Community Group Inc. identified were misstated. I am therefore rescinding the Department's letter of September 18, 2001, requesting repayment of \$58,657.

Additionally, DMR officials told us that they have taken additional measures to ensure that for-profit human service providers such as CGI comply with their commercial earnings factor limits. We believe the actions taken by DMR relative to this matter were appropriate and again recommend that it recover from CGI at least the \$463,058 in excessive profits we identified during our audit.

Auditee's Response

In response to this audit result, CGI's President provided the following comments:

In response to this finding we have explained that we applied the prevailing standard of allowing a 5% surplus across the group of state contracts. We are not alone in his perspective, and the review by DMR that resulted in the letter we received stating the \$58,657 liability we owe back to the state was performed using the same viewpoint. While we understand the viewpoint put forth by the OSA, we respectfully suggest that it escaped notice that the language that was drafted for the addendum was more restrictive than intended. Specifically, it made no allowance for the known fact that some contracts result in losses and some will experience surpluses. The standard contained in the regulations for not-for-profit providers clearly recognizes this fact, and allows losses to count against surpluses, such that the maximum surplus that may be retained from state revenues is 5% in the aggregate. Had it been clearly recognized that applying the earnings factor on a per contract basis would effectively require the contractor to bear all the losses while simultaneously capping the surplus, the maximum earnings factor likely would have been raised to a figure higher than 5% in order to compensate for the fact that losses were not allowed to enter into the calculation. Now that this issue has been raised, we respectfully suggest that it merits further review, since we believe that this is one of these situations where the spirit of the law should be considered alongside the letter of the law. There are years outside the audit period with very large losses, and over the years hundreds of thousands of dollars have been invested by the parent corporation into the operations of CGI. In addition, fiscal 2002 resulted in unusually large losses for the company, leaving the company with liabilities significantly greater than assets. At this point there will be no chance for the company to regain solvency due to the fact that DMR has cancelled all contacts with CGI. The closure of the agency also eliminated the possibility of providing free or discounted services as part of any resolution. We would hope that due consideration is given to the larger context as we try to resolve the question of the amount due back to the state.

Auditor's Reply

In its response, CGI states that it applied “the prevailing standard of allowing a 5% surplus across the group of state contracts.” To support its position, CGI implied that DMR in its review of the fiscal year 1999 UFR, and subsequent assessment of funds due back to the state, applied the same standard. However, as stated in our report, DMR miscalculated CGI’s commercial fee for fiscal year 1999 and subsequently rescinded its September 18, 2001 letter to CGI requesting reimbursement of \$58,657 in unallowable profits retained by CGI. Additionally, the 5% maximum surplus standard that CGI refers to in its response applies to not-for-profit service providers and is not relevant to CGI, which is a for-profit provider. For-profit service providers such as CGI are required to negotiate an earnings factor, which the agency did and clearly agreed to in its 1999 contract addendum with DMR, which stated:

If the provider in this contract, through cost savings initiatives and/or efficiencies, makes a profit on the contract, the provider may retain the profit or portion of it up to (5%) of the contract's maximum obligation. The provider must return any excess of this amount to the Commonwealth. The for-profit earnings factor is 5% within the current maximum obligation. No additional funds will be allocated to the current contract for the purpose of the earning factor.

This addendum clearly identifies that the amount of allowable profit is to be calculated on a contract-by-contract basis. OSD officials confirmed that this is in fact how the allowable profit amounts are to be calculated. Consequently, CGI clearly owes at least \$463,058 in excessive profits that it realized since agreeing to this addendum to the Commonwealth.

In its response, CGI contends that the language in this addendum was “more restrictive than intended.” However, CGI had ample time and the ability to negotiate its earnings factor with DMR before it agreed to this addendum. If CGI believes that the language in the addendum was too restrictive, it should have made sure it was acceptable before it agreed to these terms and conditions.

Finally, the fact that CGI may have incurred losses in some of its other contracts and during other fiscal years is irrelevant to this issue. State regulations allow for-profit providers such as CGI to negotiate the amount of profits (earnings factor) they can realize under each contract, which should be adequate to ensure proper funding to the provider. Program

losses are the result of inefficient and ineffective program management practices and not a defect in the state's regulations.

3. DUPLICATE AND UNDOCUMENTED PAYROLL AND OTHER COSTS TOTALING AT LEAST \$264,908 ALLOCATED AGAINST STATE CONTRACTS

We found that during fiscal year 1999, CGI billed and received duplicate payments totaling \$221,426 against its state contracts. We also found that during this fiscal year, CGI allocated an additional \$43,482 in expenses to state contracts that it could not document were actually incurred. According to state regulations, expenses such as these are unallowable and non-reimbursable under state contracts, and therefore CGI should return this \$264,908 to the Commonwealth.

CGI bills its state contracts for the cost of its administrative staff under a budget category titled Agency Administrative and Support. According to OSD's UFR Audit and Preparation Manual for fiscal year 1998, this budget cost category includes the following:

This component is for resources which cross all agency programs and cannot be directly associated with one program or a combination of programs. This component includes all resources reasonably necessary for the policy making, management, and administration of the provider organization as a whole and all other agency activities. It may include management, administrative, clerical and support personnel, office supplies and materials, leasing or routine replacement (depreciation and financing interest only) of office equipment, telephone, costs related to occupancy of administrative premises, advertising and recruitment, postage, printing and reproduction, administrative and support staff training and travel, officer/director/trustee compensation, parent organization costs, legal, auditing, management consultants and other professional fees, working capital interest, directors and officers insurance, and all other similar or related resources/expenses that are not directly attributed to one or more programs. The reimbursable price cannot include resources defined as Non-Reimbursable Costs by regulations 808 CMR 1.15.

Our review of the administrative and support expenses CGI allocated to state contracts during the audit period identified that CGI's administrative overhead rate almost doubled between fiscal year 1998 to 1999, as detailed below:

CGI
Administrative Costs Summary
Fiscal Years 1998 and 1999

	1998	1999
Amount of Administration and Support Expense	\$396,750	\$788,831
Total Expenses	\$3,695,691	\$3,896,547
Administrative Overhead Rate	10.74%	20.24%

As a result of this material increase in the percentage of agency administrative expenses being charged by CGI to its state contracts, we requested from CGI officials supporting documentation to substantiate the nature and reasonableness of these administrative expenses. Based on the documentation CGI staff provided, we identified a double billing during fiscal year 1999² of \$221,426 (\$197,702 in payroll and \$23,724 in fringe benefits) in direct care salary costs. Specifically, CGI billed these salary costs as direct expenses against three of the contracts that funded CGI's residential programs and subsequently included these expenses in the agency's overhead expense account and billed (allocated) 100% of these costs again to all of CGI's state contracts.

OSD has promulgated regulations that defines certain expenses that are nonreimbursable under state contracts. Specifically, 808 CMR 1.05(26) and 1.05(20) identify the following as nonreimbursable costs:

1.05(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.

1.05(20) Non-Program Expenses. Expenses of the contractor, which are not directly, related to the social service Program purposes of the contractor.

During our review of CGI's fiscal year 2000 administrative expenses we also found that CGI had no documentation to substantiate \$43,482 in expenses that were allocated to state contracts under the "other products" line item in the agency's UFR for this fiscal year.

² Although our audit testing in this area covered fiscal years 1999 and 2001, we only identified this problem in CGI's fiscal year 1999 expenses.

Regarding these duplicative and undocumented expenses, on February 13, 2002, CGI's legal counsel provide us with a memorandum that stated, in part:

In previous communications CGI informed the Auditor's office that the reason for the dramatic increase in administrative overhead was due to the improper spreading of certain staff costs to the various programs subject to the state contracts. Based upon your office's further inquiry, we have looked deeper into the issue. What we have found is that certain staff improperly incorporated in the administrative cost items should have been listed separately as program staff. Correcting this error results in what appears to be a dramatic increase in certain staffing costs. It is conceded that in a sense this situation is indicative of sloppy accounting. During our meetings it has been conceded that unfortunately there were some sloppy accounting being done. This has been the result in part to changes over the audit years of auditors, internal financial staff and simply not proper care to attention. It is unfortunate that an audit such as the one being conducted by your office is the mechanism whereby these issues are recognized. Nonetheless, such is the root of some of the confusion. It is deeply regretted that these issues have caused the audit process to be more complicated for all concerned.

Subsequent to providing us with this memorandum, CGI officials claimed that the \$43,482 billed as "other products" was actually for accrued vacation expenses. However, as agency officials did not provide us with any documentation to substantiate that these expenses were actually incurred, they are undocumented and clearly unallowable in accordance with state regulations.

Recommendation

In order to address our concerns relative to these matters, DMR and OSD should determine how much to recover of the \$264,908 in duplicative and undocumented salary and other expenses that CGI allocated to its state contracts during fiscal year 1999. Further, DMR should conduct its own review of the administrative expenses CGI allocated against its state contracts during the periods prior and subsequent to those periods covered by our audit testing. Based on this review, DMR should recover whatever additional funds it deems appropriate. In the future, CGI should take measures to ensure that all billings against any state contracts are reasonable, allowable, allocable to the contracts, and adequately documented.

Auditee's Response

In response to this audit result, CGI's President provided the following comments:

As indicated during our audit, we do not agree that we billed and received duplicate payments. All of the payments received were on maximum obligation contracts. Even when a provider has accidentally issued a bill twice, the state does not pay beyond the maximum obligation. The finding states the certain payroll and fringe expenses, "were billed (allocated)" to the overhead expenses when they were supposed to have been allocated to the direct expenses. A payroll and general ledger allocation is not the same as a bill to the state, and we suggest that there should be a clearer distinction when this finding is presented. It is true that the expenses were inappropriately allocated to overhead and had to be reallocated to direct expenses. There is no indication, however, that the state was billed twice due to the misallocation of these expenses.

The second part of the finding states that there was \$43,482 in expense that was undocumented, and therefore the expense should be disallowed and funds returned to the state. We acknowledge that there were lax internal controls and accounting procedures that resulted in any areas of the company not following proper accounting and documentation standards, primarily use to unusually frequent turnover on the accounting staff during this period. The controller for many years had left, and as the Auditor notes in the last finding on internal controls, we did not have a formal accounting procedures manual and when experienced personnel left the records were not maintained properly. This does not mean, however, that the expenses in question did not occur.

Auditor's Reply

Contrary to what CGI states in its response, during fiscal year 1999, CGI billed and received from the state as much as \$221,426 in unallowable salary costs for several of its direct care staff. As stated in our report, CGI provided us with documentation that identified that these employees were direct care workers for whom CGI directly billed against three of its state contracts. This documentation also disclosed that the salaries of these direct care staff were also included by CGI in its overhead expense accounts and subsequently billed a second time to the Commonwealth as indirect expenses. Since CGI was already directly reimbursed for the salary costs of these employees through its billings against its state contracts, billing these same costs as overhead expenses against state contracts clearly represents duplicate charges by CGI. It should also be noted that even if CGI removed these duplicate expenses from its financial statements, it would still have the effect of increasing the unallowable

profits the agency earned during this fiscal year (See Audit Result No. 2) by at least an additional \$203,979, as indicated in the table below:

**Community Group Inc.
Revised Unallowable Profit Calculations
Fiscal Year 1999**

Fiscal Year 1999	Program # 10	Program #30	Program #50	Program #62	
Max. Obligation	\$1,427,159	\$506,736	\$211,367	\$202,569	
Allowable Profit	71,358	25,337	10,568	10,128	
Total Revenue	1,537,362	539,667	231,936	203,845	
Total Expenses	1,192,248	474,606	213,796	185,814	
Revised Expenses**	1,049,198	440,168	197,901	175,218	
Revised Actual Profit	488,164	99,499	34,035	28,627	
Revised Unallowable Profit	416,806	74,162	23,467	18,499	\$532,934
					<u>(328,955)*</u>
					<u>\$203,979**</u>

* Amount previously detailed in Audit Result No. 2

** Includes removal of duplicative overhead expenses

Consequently, CGI would owe at least \$203,979 in unallowable profits to the Commonwealth.

As stated in our report, CGI did not have any documentation to substantiate that the \$43,482 in expenses allocated to CGI's "other products" expense category in its fiscal year 1999 UFR were actually incurred. According to state regulations, undocumented expenses such as these are unallowable. CGI had ample time during the conduct of our audit fieldwork to provide us with any records it may have had relative to these expenses but failed to do so. Therefore, the agency owes this \$43,482 to the Commonwealth.

4. UNDOCUMENTED AND UNALLOWABLE MANAGEMENT FEE EXPENSES TOTALING \$75,000

During fiscal year 2000, CGI charged \$75,000 in management fees to its state contracts for services purportedly provided by CGI's Executive Director on behalf of FCI. However, CGI could not provide us with any documentation to substantiate that these management services were actually provided. According to state regulations, expense such as these that

are undocumented or non-program-related are unallowable and nonreimbursable under state contracts, and therefore CGI should return this \$75,000 to the Commonwealth.

In addition to the management services CGI's Executive Director claimed to have provided to CGTC and CGI during fiscal years 1997 through 2000 (See Audit Result No. 1. a.) during fiscal year 2000, CGI also charged \$75,000 directly against its state contracts and paid FCI for management fees purportedly provided by the agency's Executive Director on behalf of FCI. Given that CGI's Executive Director is a full-time employee of the agency and is already responsible for its administration, we asked CGI officials to provide us with documentation to substantiate what other management services CGI's Executive Director may have provided to the agency. In response, CGI's Executive Director provided us with a one-page management agreement³ dated October 1, 1999 that stated the following:

This letter serves to document the following agreement set forth here for Management Services to be provided by First Community, Inc, to Community, Inc. Community Group, Inc hereby agrees to compensate First Community, Inc. a total of \$75,000 (Seventy Five thousand dollars) for management services provided during the period October 1, 1999 through September 30, 2000.

However, neither CGI nor FCI could provide any supporting documentation to substantiate what additional management services may have provided by CGI's Executive Director and how these services related to CGI's state-funded programs. Consequently, this \$75,000 is an unallowable expense in accordance with the previously cited state regulations 808 CMR 1.05(26).

Recommendation

DMR, in conjunction with OSD, should recover from FCI the \$75,000 in undocumented and unallowable management expenses purportedly provided by its Executive Director that CGI charged against its state contracts and paid to FCI during fiscal year 2000. In the future, CGI should take measures to ensure that it adequately documents all expenses that it bills against any state contacts.

³ It should be noted that the FCI stationery on which this management agreement was printed had the same corporate business address as CGI.

Auditee's Response

In response to this audit result, CGI's President provided the following comments:

While the financial statements disclose the fee, we do not believe that the fee was actually disbursed, rather it was booked as a payable. Regardless, to the extent that this fee would be non-reimbursable under state contracts, we would not dispute that it is non-reimbursable.

Auditor's Reply

In its response, CGI contends that it is uncertain as to whether CGI actually disbursed this \$75,000 to its President. This statement is very concerning, given that it is CGI's President, who is also the President of FCI, who is making this statement. In our opinion, the President most assuredly should be aware of whether he received this \$75,000 lump-sum payment from CGI.

Regardless of what CGI's President asserts in his response, our review of CGI's financial records revealed that on September 30, 2000, CGI deposited this \$75,000 into an accounts payable account to FCI and subsequently transferred these funds to FCI. Since neither CGI nor its President could provide us with adequate documentation to substantiate the reasonableness of the transfer of these funds, these expenses are clearly unallowable and nonreimbursable under CGI's state contracts.

5. INADEQUATE CONTROLS OVER THE USE OF CORPORATE CREDIT CARDS RESULTED IN \$75,197 IN UNALLOWABLE CREDIT CARD EXPENSES

During the period October 1, 1998 through September 30, 2000, CGI permitted three members of its administrative staff to use its American Express corporate credit cards. Two of these members also were allowed to use an FCI American Express credit card that was being utilized by CGI to pay for CGI expenses. However, we found that CGI had not established adequate controls over the use of these credit cards. Our examination of the credit card expenditures made by these staff members during our audit period revealed that 186 expenditures totaling \$75,197 charged to state contracts were questionable in that they were either inadequately documented or did not appear to be related to the social service program purposes of CGI's state-funded programs. Examples of such inadequately

documented expenditures include \$2,010 in restaurant charges, \$4,711 in car rentals, and \$13,978 in hotel charges. According to state regulations, expenses such as these that are inadequately documented or not directly related to the state-funded program activities of service providers are nonreimbursable under state contracts, and therefore CGI should return this \$75,197 to the Commonwealth.

During the period October 1, 1998 through September 30, 2000, CGI permitted three members of its administrative staff to use its American Express corporate credit cards, and two of these members were also allowed to use an FCI American Express credit card that was used by CGI to pay for CGI purchases. During this period, these staff members charged 409 purchases totaling \$158,763 to state-funded programs, as shown in the following table:

CGI
Summary of Credit Card Expenses
October 1, 1998 through September 30, 2000 (combined)

Administrative Staff	Charged to CGI Credit Card	Charged to FCI Credit Card	Total
Executive Director	\$ 2,360	\$ 2,053	\$ 4,413
Assistant Executive Director	52,258	69,236	121,494
Controller	<u>32,856</u>	<u>N/A</u>	<u>32,856</u>
Total of Credit Card Expenses	<u>\$87,474</u>	<u>\$71,289</u>	<u>\$158,763</u>

Our assessment of CGI's internal controls over these credit card expenditures indicated that CGI had not implemented proper controls in this area. Specifically, CGI did not have written policies and procedures in place relative to the use of these cards and did not require credit card holders to submit documentation (e.g., the original receipt indicating the date, place, amount, and nature of the expense) detailing the incurrence and nature of each expense. Additionally, no member of CGI's staff performed an independent review of the expenditures to assess their reasonableness and allocability to state contracts.

Based on these internal control deficiencies, we reviewed all the documentation CGI was maintaining relative to the \$158,763 in credit card expenses it billed against its state contracts between October 1, 1998 and September 30, 2000. Based on our review, we found that CGI

billed and received payments from the Commonwealth for \$75,197 in credit card expenses that were either inadequately documented or appeared to be unrelated to the social service purposes of CGI's state-funded programs, as indicated in the following table:

CGI
Summary of Inadequately Documented and Non-Program-Related Expenses
October 1, 1998 through September 30, 2000

	Amount
Inadequately Documented Expenses	\$71,612
Non-Program-Related Expenses	<u>3,585</u>
Total	<u>\$75,197</u>

The inadequately documented expenses included expenses for which CGI lacked invoices, receipts, or other documentation to substantiate the nature or purpose of the expenses. Examples of the non-program-related expenses include the following:

- Gift purchases totaling \$1,585, including two purchases on September 21, 1999 for \$407 and one on October 3, 1999 for \$460 at Coach Leatherware
- A \$2,000 donation to the Boston Symphony Orchestra on August 22, 2000

Regarding this matter, CGI officials did not comment on why the agency did not maintain the required documentation relative to these credit card expenses or why it had not established adequate controls in this area.

Recommendation

In order to address our concerns relative to these matters, DMR should recover the \$75,197 in inadequately documented and non-program-related expenditures that CGI charged against its state contracts during the period October 1, 1998 through September 30, 2000. Also, DMR, in conjunction with OSD, should perform a review of the credit card expenditures made by CGI and charged to its state contracts during the period prior and subsequent to that covered by our audit testing. Based on this review, OSD and DMR should recover whatever additional funds they deem appropriate. In the future, CGI should establish and implement internal controls over the use of credit cards by staff members. At a minimum,

such controls should require credit card holders who use corporate credit cards for business purposes to obtain prior authorization for these expenditures and maintain and submit to CGI adequate documentation relative to business purposes of each expense. In addition, any such documentation relative to each expense should be reviewed by independent members of CGI's administrative staff (typically its chief financial officer) for approval prior to CGI paying these expenses.

Auditee's Response

In response to this draft audit result, CGI's President provided the following comments:

We do not dispute that there were inadequate controls over the use of the credit cards, which resulted in some expenses that were non-reimbursable being inappropriately classified as reimbursable expenses.

Response to both findings [No. 4 and No. 5] regarding liability to the state:

Classifying an expense as non-reimbursable does not automatically produce a liability due back to the state. We understand that Auditor's opinion regarding the liability, since UFR compliance manual states, in part, "Nonreimbursable costs that exist and have not been disclosed are presumed to have been defrayed using Commonwealth and Federal funds." The basis for the report's position is due to the fact that the non-reimbursable costs were not properly disclosed, which we do not dispute. The appropriate resolution for this issue, though, requires us to go beyond presumption.

The resolution regarding finding #1 concerns the disposition of the commercial income, which would indicate that there were more than sufficient revenues available to cover the non-reimbursable costs without utilizing state revenues. It is our belief that had the commercial income and non-reimbursable costs been disclosed and reported properly in the financial statements, the situations described in #1, #4 and #5 would not have produced audit findings. To the extent that there are findings, however, the proper resolution for findings #4 and #5 depends upon the availability of sufficient non-state revenues, which we believe was satisfactorily addressed in the response to #1. Our position is derived from the statements contained in the UFR Audit and Preparation Manual regarding the Subsidiary Schedule B-1 for Itemized Nonreimbursable Costs. One paragraph states the following:

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

The manual supports the presumption the state or public revenues were utilized if other funds were not properly disclosed. Once there has been a final ruling regarding the correct determination of the commercial income, if necessary in order to address this issue we can re-file the financial statements for the period under

audit, which will properly disclose the commercial income and non-reimbursable costs, and thus remove the presumption of use of state revenues.

Auditor's Reply

In its response, CGI acknowledges that it had inadequate controls over the use of credit cards and asserts that “classifying an expense as non-reimbursable does not automatically produce a liability due back to the state.” To the contrary, since these expenses that were billed by CGI against its state contracts were not adequately documented, according to state regulations, they are clearly not allowable, and the funds CGI billed against its state contracts for these expenses should be remitted. As stated in our report, our issue is not with expense classifications as CGI references in its response but with CGI’s billing of undocumented costs to its state contracts.

6. INADEQUATE DOCUMENTATION TO SUBSTANTIATE THE ALLOCATION OF \$1,767,768 IN ADMINISTRATIVE PAYROLL EXPENSES

We found that, contrary to state regulations and the terms and conditions of its state contracts, CGI had not established adequate controls over the allocation of payroll expenses for its salaried employees. Specifically, although CGI had policies and procedures relative to the preparation and maintenance of payroll records, including weekly timesheets for its hourly (direct care) employees, these policies and procedures did not require CGI’s salaried employees to complete weekly records documenting the hours worked and the functions benefited (e.g., specific program, cost center). As a result, there is inadequate assurance that all of the approximately \$1,767,768 in salaries and related costs that CGI allocated against its state contracts for its salaried employees during our audit period was accurate.

OSD has promulgated Terms and Conditions for Human and Social Service Contracts (General Contract Conditions), with which all human services providers that contract with state agencies must comply. According to these General Contract Conditions, contacted human services providers such as CGI are required to maintain accurate and complete financial records, including payroll records, in order to receive reimbursement of these costs. Specifically, these General Contract Conditions state, in part:

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

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

The Contractor and its Subcontractors shall keep on file all data necessary to satisfy applicable reporting requirements of the Commonwealth (including DPS [now OSD], the Division of Health Care Finance and Policy and Departments), and financial books, supporting documents, statistical records, and all other records which reflect revenues associated with and costs incurred in or allocated to any Program of services rendered under the Contract. The Contractor and its Subcontractors shall maintain records of all types of expenses and income or other funds pertaining to the Program paid to the Contractor by every source, including from each Client. Books and records shall be maintained in accordance with generally accepted accounting principles as set forth by the American Institute of Certified Public Accountants (AICPA); which for not-for-profit Contractors shall be the Industry Audit Guide for Audits of Voluntary Health and Welfare Organizations, unless otherwise provided in the UFR. . . . If the Contractor or a Subcontractor receives any federal funds from the Commonwealth, directly or through subcontract, the Contractor or Subcontractor shall also keep data necessary to satisfy Federal Office of Management and Budget (OMB) Circular A-133, or successor provision and shall also maintain books and records in accordance with OMB Circular A-110 and OMB Circular A-122, or successor provisions.

Finally, the Commonwealth of Massachusetts Procurement Policies and Procedures Handbook issued by OSD pursuant 801 CMR 21 and 808 CMR 1.00 states, in part:

Personnel and Payroll Records. Personnel records must be sufficient to meet all state and federal employment wage and labor standards, GAAP internal control needs and industry reporting requirements. The personnel and payroll records maintained by the contractor and subcontractor must also adequately and clearly document all staff time directly charged or allocated to state or federally funded contracts. To meet the above standards, most contractors will need to maintain resumes, job applications, statements of job descriptions and responsibilities, statement of job qualifications, payroll records, and time and attendance records or effort reports in keeping with the documentary requirements of the Fair Labor Standards Act of 1938 as amended, MGL Chapter 151 and OMB Circular A-122 or OMB Circular A-21.

During fiscal years 1997 through 2000, CGI received reimbursements under its state contracts for approximately \$1,767,768 in salary, fringe benefits, and related expenses for its salaried staff, as indicated in the following table:

CGI
Summary of Salaried Employee Costs and Related Expenses
Fiscal Years 1997 through 2000

Fiscal Year	Salaries	Fringe Benefits (21.5%)	Totals
1997	\$324,468	\$ 29,174	\$ 353,642
1998	281,686	26,933	308,619
1999	482,297	176,553	658,850
2000	<u>410,599</u>	<u>36,058</u>	<u>446,657</u>
Total	<u>\$1,499,050</u>	<u>\$268,718</u>	<u>\$1,767,768</u>

During our audit, we reviewed the policies and procedures CGI had implemented relative to the maintenance of its payroll records. Our review revealed that CGI requires all staff who are compensated on an hourly basis to submit weekly payroll records that indicate the hours worked by the individual and any leave taken during the period. These payroll records must be signed by the employee and approved by the employee's supervisor prior to the employee's being paid. In contrast, CGI does not require any of its salaried employees to submit payroll records to document the hours they work or indicate which programs they worked in. While we do not question that members of CGI's staff provided services during these four fiscal years, based on this lack of weekly payroll records, there is inadequate assurance that all of the \$1,767,768 in these expenses that CGI allocated to its state contracts were actually incurred by program staff.

In response to these matters, CGI's Executive Director stated that he did not know that it was a requirement to document the hours of his administrative staff detailing the hours worked and functions benefited. He also stated that he would immediately institute a policy requiring that timesheets for administrative staff indicating the hours worked and function benefited be completed on a weekly basis.

Recommendation

CGI should develop and implement policies and procedures relative to the maintenance of payroll records for its administrative employees that are in compliance with OSD guidelines. These policies and procedures should require all employees to complete weekly payroll records documenting hours worked and functions benefited (e.g., program, cost center,

contract), and employees and their supervisors should sign these payroll records. In addition, the allocation of all costs, including those of salaried employees, should be adequately documented and based on an allocation methodology that is consistent with OSD regulations.

Additionally, DMR, in conjunction with OSD, should review all expenses reimbursed by the Commonwealth to CGI for salaried employees during the period covered by our audit as well as the periods prior and subsequent to our audit to assess their propriety. Based on this review, DMR should take whatever steps it deems necessary to resolve this matter.

Auditee's Response

In response to this audit result, CGI's President provided the following comments:

As previously mentioned, we accept the observation that there were not adequate internal controls and procedures. Specific to this finding, it was not clearly understood that salaried employees had to file timesheets in a similar fashion to the hourly employees. As mentioned during the audit, we now understand the requirements and the situation has been rectified going forward. This was observed to have occurred in the area of administrative employees, who are not allocated directly to contract but spread across contracts proportionally as part of overhead expenses. Therefore, we believe that there was no impact on the accuracy of the financial statements as a result of not having detailed timesheets for those employees. The administrative expenses would have been the same, and the allocation of those expenses would have been the same.

Auditor's Reply

Based on its response, CGI has taken measures to improve the controls in this area. However, although the method of allocation of administrative salary costs may not affect the accuracy of CGI's financial statements, the fact remains that there is inadequate documentation to substantiate that the hours worked by these individuals and billed by CGI against its state contracts were accurate. Consequently, CGI and its state-purchasing agency should fully implement the recommendations made in our report.

7. UNALLOWABLE SALARY RESERVE EXPENSES TOTALING \$38,484

We found that, contrary to the terms and conditions of its state contracts, CGI failed to use \$38,484 in state funds that was supposed to provide temporary salary increases to its lowest-

paid direct-care staff members. Rather, CGI used these funds to finance other operational activities. As a result, CGI should reimburse the Commonwealth \$38,484.

Since 1984, the state Legislature has funded various initiatives, commonly referred to as salary reserve funding, to address the issue of relatively low wages being paid to direct-care staff by human services provider contracting with state agencies. Salary reserve funding is provided to contracted human services providers under individual salary reserve contracts that providers enter into with their state purchasing agencies. An employee of a provider is eligible to receive salary reserve funding if they meet the following criteria:

- Earn less than the statutory amount per year, which is calculated on base pay (without overtime). Part-time employees who earn the statutory per hour rate are also eligible. The statutory rate and amount change each year.
- Work in human and social services contracted within the Executive Office of Health and Human Services (EOHHS) or the Executive Office of Elder Affairs (EOEA).

Under salary reserve contracts, each service provider is also permitted to use up to 15% of their allocation to cover administration costs associated with increases paid to eligible employees.

Once OSD establishes the allocation of salary reserve funds, each provider enters into a separate salary reserve contract with their state-purchasing agency. These salary reserve contracts contain standard conditions, as follows:

- All funds received through the agreement will be used only for salary increases and the employer portion of payroll and fringe benefit obligations directly associated with the salary increase for eligible personnel. . . .
- Reserve funds would otherwise go unspent because of staff turnovers as redeployment may be used at the contractor's discretion for eligible employees.
- Salary increases are retroactive to July 1, where appropriate.
- If the contractor's allocation includes funds for a subcontractor's eligible personnel, the contractor is required to disburse those funds and enter into a written agreement consistent with and subject to the same terms as this agreement with its

subcontractor. The contractor is responsible for assuring its subcontractor's compliance with the terms of the agreement.

According to the terms and conditions of these contracts, providers are required to maintain adequate documentation relative to their administration of salary reserve funds. Specifically, these contracts state, in part:

The Contractor must maintain detailed data to support the salary survey submission or review and documentation describing how the funds were actually distributed for all fiscal year salary reserve agreements.

Should the Contractor fail to comply with any of the terms of this agreement the funds are subject to immediate recoupment, through repayment by the Contractor, intercept through the Office of the State Comptroller, or such other actions as may be necessary to recover such funds, costs or damages for breach of this agreement.

Further, Attachment A of the standard salary reserve contract states, in part:

By signing the Standard Contract Form, the Contractor certifies, under pains and penalties of perjury that it shall also comply with all of the following provisions and shall remain in compliance with these provisions for the life of this agreement.

Should the contractor fail to comply with any terms of this agreement the funds are subject to immediate recoupment, through repayment by the Contractor, intercept through the Office of the State Comptroller, or such other actions as may be necessary to recover such funds, costs or damages for breach of this agreement.

During our audit, we first assessed the controls CGI had established relative to its administration of salary reserve funds. Based on our review, CGI had not established any policies or procedures to administer the receipt, payment, or maintenance of records for salary reserve funds. Consequently, during our audit we assessed the use of salary reserve funds by CGI to determine the agency's compliance to the terms and conditions of its salary reserve contracts.

During fiscal year 1999 CGI entered into one salary reserve contract with DMR in the amount of \$67,124. We found that CGI had appropriately retained 15% of the total, or \$10,069, for administrative fees and had \$57,055 remaining to disburse to its qualified employees. However, we determined that CGI did not disburse \$10,810 of this \$57,055 to

eligible employees or return these funds to the Commonwealth as required by its contract. During fiscal year 2000, CGI had one salary reserve contract with DMR in the amount of \$83,841. CGI retained 15% of the total, or \$12,576, for administrative fees and had \$71,265 available to disburse to qualified employees. We found, however, that CGI only disbursed \$43,591 of the \$71,265 and did not disburse the remaining \$27,674 to eligible employees or return the funds to the Commonwealth as required by its contract. The following table summarizes our work in this area at CGI.

UNALLOWABLE SALARY RESERVE EXPENSES

Fiscal Year*	Funding Agency	Contract Amount	Unallowable Expense
1999	DMR	\$ 67,124	\$10,810
2000	DMR	<u>83,841</u>	<u>27,674</u>
Totals		<u>\$150,965</u>	<u>\$38,484</u>

*Fiscal year 2001 was tested but no exceptions were noted.

Regarding this matter, CGI's current Executive Director stated that the agency agrees with our findings in this area and has taken actions, including terminating the employee responsible and implementing better controls over the administration of these funds.

Recommendation

In order to resolve this issue, DMR in conjunction with OSD should recover from CGI the \$38,484 in misused salary reserve funding. Also, CGI should take measures to ensure that any salary reserve funding it may receive in the future is used only for the intended purposes.

Auditee's Response

In response to this audit result, CGI's President provided the following comments:

We do not dispute the finding.

8. INADEQUATE ADMINISTRATIVE AND INTERNAL CONTROLS OVER CERTAIN AGENCY OPERATIONS

We found that CGI had not developed and implemented an adequate system of internal controls over various aspects of its operations. Specifically, we found that CGI did not properly document its accounting system, improperly accounted for inter-company transfers,

did not maintain all of its records in accordance with state regulations, failed to establish an effective inventory system for its fixed assets, and did not establish proper security over access to its computer-based accounting records. As a result, the Commonwealth cannot be assured that public funds were properly safeguarded against misuse and expended for their intended purposes, or that all of CGI's transactions were properly authorized, recorded, and reported.

According to GAAP, entities such as CGI should establish and implement an adequate internal control system within the organization to ensure that goals and objectives are met; resources are used in compliance with laws, regulations, and policies; assets are safeguarded against waste, loss, and misuse; and financial data are maintained, reported, and fairly disclosed in reports.

In order to comply with GAAP, CGI is required to have a documented comprehensive plan of internal control describing its goals and the means by which these goals and objectives could be achieved. An effective internal control system would establish clear lines of authorization and approval for its various business functions, such as purchasing, contracting, asset management, travel, payroll, and personnel, as well as identify supervisory personnel and their responsibilities. In addition, an entity's internal control system should be backed up with a set of detailed subsidiary policies and procedures that would communicate responsibilities and expectations to subordinate staff throughout the organization. These policies and procedures would provide direction to employees on how to complete the various business functions, such as accounting, billing and receiving, cash receipts, accounts payable, human resources, and payroll. However, we found that in addition to the internal control problems discussed in Audit Results No. 1 through 7, CGI had not established adequate internal controls over several other aspects of its operations. The following is a summary of the additional internal control issues we identified during our audit.

- Failure to Document Accounting System: Sound business practices advocate that entities such as CGI establish a proper accounting system that is documented in formal policies and procedures and a written accounting manual, which describes the

accounting system and the policies and procedures that are utilized in the agency's accounting process. Such a manual not only maintains the integrity of the accounting process and its continuity in case of staff turnover, but also establishes accountability of various operation activities. However, during our review we noted that CGI had not established formal written accounting procedures or an accounting manual.

- Inappropriate Accounting for Inter-Company Transactions: We found accounts in CGI's General Accounting Ledger that were used by the agency to record transactions between CGI, FCI and CGI's Executive Director. As noted in Audit Result No. 1, our analyses of these accounts identified a number of questionable and undocumented transfers within these accounts. Additionally, our analyses revealed that these accounts were not reconciled on a consistent basis during the audit period and that consequently CGI officials could not provide us with supporting documentation to substantiate the beginning balances in any of the accounts in its General Accounting Ledger as of the beginning of our audit period (October 1, 1996).
- Failure to Maintain Records in Accordance with State Regulations: According to 808 CMR 1.04 (1) promulgated by OSD, entities such as CGI are required to maintain all financial records relative to revenue and expenses in accordance with GAAP as set forth by the American Institute of Certified Public Accountants for a period of seven years. However, as noted throughout this report, CGI officials were unable to provide us with numerous documentation requested during the audit.
- Failure to Maintain an Accurate Inventory System: The 808 CMR 1.04, promulgated by OSD, states the following with regard to inventory of equipment and furnishings and other goods: "Any Contractor in possession of Capital Items. . . shall maintain and keep on file a written inventory of the property in accordance with generally accepted accounting principles." However, during our audit we found that CGI did not have a listing of its fixed assets (nonexpendable items with a useful life of more than one year) in accordance with state regulations, which according to its fiscal year 2001 financial statements had a value of \$44,260.
- Inadequate Controls over Computer-Generated Records and Reports: During our audit, we found that the computer system CGI was maintaining for its financial and accounting records did not have adequate controls to ensure the integrity of the information within the system. Specifically, we found that access to this information was not protected by password access or other controls that would preclude access by unauthorized staff members.

Regarding these matters, CGI officials did not comment on why they had not implemented adequate internal controls over all agency operations.

Recommendation

CGI should immediately develop and implement a written system of internal controls over all aspects of its operations in order to ensure that its financial records are properly maintained and that its financial activities are properly authorized, recorded, and reported.

Auditee's Response

In response to this audit result, CGI's President provided the following comments:

We acknowledge the lack of rigorous internal controls, particularly with regard to the accounting policies and procedures. We do not dispute the finding and accept the recommendations.

SUBSEQUENT EVENTS

Subsequent to the conclusion of our audit fieldwork at CGI, the following significant events took place at the agency:

1. CGI's administrative offices moved from 140 Gould Street in Needham, Massachusetts to 338 Rear Main Street, Wakefield Massachusetts.
2. Ms. Diane Fleming, CGI's Assistant Executive Director, resigned effective August 9, 2002.
3. On August 16, 2002, Mr. David Slater resigned his position as CGI's Executive Director and assumed the position of President of CGI. On this date, he also appointed Ms. Deborah Anthony as CGI's Executive Director.
4. On August 16, 2002, Mr. Robert Lussier was appointed Controller of CGI.
5. On October 15, 2002, DMR contacted the Office of the State Auditor and the Office of the Attorney General to inform them that DMR had reason to believe that CGI failed to disclose a related-party transaction with Middle Street Realty Trust and had attempted to obligate DMR to a rental increase through an apparently forged document.
6. On October 17, 2002, Victor Kaufman as trustee for Middle Street Realty Trust filed a complaint (C.A. No. MICV 2002-04370D) in Middlesex Superior Court against CGI, South Shore Mental Health Inc., DMR, and Karyn Dion, DMR South Coastal Area Director, for trespass, breach of contract, violation of constitutional rights, and violation of Chapter 93A of the Massachusetts General Laws. A hearing on Kaufman's request for injunctive relief was held on October 25, 2002. On January 3, 2003, Judge Isaac Borenstein denied Kaufman's request for injunctive relief.
7. On October 22, 2002, DMR sent a letter to CGI's current Executive Director, notifying her of the department's decision to terminate, without cause, its contracts with CGI effective December 21, 2002. DMR officials informed the OSA that many of the services currently being provided by CGI would be provided under contracts with other human services providers. DMR also informed the OSA that they would be referring this matter to the Commonwealth's Office of the Attorney General.
8. On October 24, 2002, CGI's legal counsel informed the OSA that CGI's President, Mr. David Slater, had terminated his services with CGI effective immediately.
9. On October 25, 2002, Ms. Deborah Anthony informed the OSA that both she and Mr. Robert Lussier had resigned from their positions at CGI effective immediately.

10. On October 25, 2002, CGI's Board of Directors appointed Mr. Martyn Berliner as interim Chief Executive Officer and Executive Director of CGI.
11. According to CGI officials, the agency ceased operations as of midnight on December 21, 2002.

APPENDIX

Listing of CGI Programs with Excess Profits

Program Name and /or Location Per UFR	Program UFRs Number by Fiscal Year			
	1997 UFR	1998 UFR	1999 UFR	2000 UFR
Community Training Center	1	01	40	01
Avon/Pleasant Street	2	02	10	02
Bassett/Udham	3	03	20	03
Weymouth	6	06	30	06
Lowell Individual Support	10	10	61	10
T & J Dracut	11	11	56	N/A
Lowell Women	N/A	12	N/A	11
North Shore Individual Support	N/A	13	62	13
Pine Valley	N/A	N/A	50	N/A
Metro North Individual Support CR	N/A	N/A	63	14
Metro North Individual Support UR	N/A	N/A	64	N/A