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INDEPENDENT STATE AUDITOR'S
REPORT ON CERTAIN ACTIVITIES OF
SPECTRUM HEALTH SYSTEMS, INC.
JANUARY 1, 1992 TO DECEMBER 31, 2002

OFFICIAL AUDIT
REPORT
FEBRUARY 26, 2004

INTRODUCTION
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Spectrum Health Systems, Inc., (Spectrum) was incorporated in 1969 as a private, not-for-profit corporation. Presently, Spectrum maintains a full-time staff of 800 clinicians, caseworkers and other professionals who serve adolescents, adults, and criminal justice populations throughout eastern and central Massachusetts for substance abuse and mental health and behavioral health care issues. Spectrum also provides out-of-state services that include adolescent services in Hawaii and services for criminal justice populations in Georgia, Illinois, North Carolina, and Rhode Island. (Appendix I of this report further details Spectrum's programs and service locations within the Commonwealth.) Our audit, which covered the period January 1, 1992 to December 31, 2002, had the following objectives: (1) review, analyze, and evaluate Spectrum's controls over state contracts; (2) determine whether such controls are adequate to safeguard state funds and in compliance with laws, rules, and regulations; and (3) ensure that Spectrum's charges to state contracts are reasonable, allowable, and applicable to contracted program services. Our audit identified \$13,689,206 in unallowable and highly questionable payments to related parties; \$995,000 in unallowable compensation paid to the Chairman of Spectrum's Board of Trustees; \$1,550,444 in nonreimbursable expenses funded with state program revenues; \$1,151,540 in out-of-state program expenses funded with state program revenues; and \$42,695 in unallowable and questionable travel expenses. During our audit, we found that Spectrum's current administration has improved the overall efficiency and effectiveness of the agency's operations by reducing its administrative costs and taking steps to comply with state regulations.

AUDIT RESULTS
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1. SPECTRUM PAID EXCESSIVE MANAGEMENT AGENCY FEES TO ITS RELATED PARTY, CIVIGENICS, WHICH RESULTED IN UNALLOWABLE CHARGES TO THE COMMONWEALTH TOTALING APPROXIMATELY \$10.2 MILLION
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Our audit identified that Spectrum paid excessive management agency fees to its related party, CiviGenics, which resulted in unallowable charges to the Commonwealth totaling \$10,238,334. Spectrum paid these fees through a series of contracts that it noncompetitively awarded to CiviGenics during fiscal years 1996 through 2002. The purported intent of these contract awards was to reduce Spectrum's management and general operating expenses by sharing common costs (e.g., personnel, rent, equipment lease, and office expenses) with CiviGenics. However, from the onset, Spectrum's Board of Directors allowed CiviGenics' management fee to escalate beyond limits established by the state's Operational Services Division (OSD). This problem persisted through fiscal year 2002, at which time Spectrum discontinued its contractual relationship with CiviGenics and resumed control of its day-to-day administrative operations.

2. SPECTRUM'S PURCHASE OF A MENTAL HEALTH FACILITY FROM ITS RELATED PARTY, CIVIGENICS, RESULTED IN \$3.3 MILLION IN UNALLOWABLE AND HIGHLY QUESTIONABLE EXPENSES BEING CHARGED TO THE COMMONWEALTH **17**

On May 31, 2000 Spectrum purchased Boston Road Clinic, Inc., (BRC) and CiviGenics Management Services, Inc., (CMS) from its related party, CiviGenics, for \$3,273,100. Our review of this transaction revealed that the purchase price was unreasonable and inflated because it included \$2,674,917 in goodwill for which Spectrum received no tangible assets. As of June 30, 2003, \$454,736 of this goodwill has been charged to state contracts. Moreover, because Spectrum financed this purchase over a 10-year period, as of December 31, 2002, Spectrum has incurred interest expenses attributable to this goodwill totaling \$233,352. Lastly, although Spectrum has not contracted with the Commonwealth to provide mental health services at BRC, for the two-year period ended June 30, 2002, Spectrum used Commonwealth funds totaling \$2,611,252 to cover operating losses incurred at this clinic. Based upon state regulations, these expenses are unreasonable and non-program-related, and therefore represent nonreimbursable costs to the Commonwealth.

3. SPECTRUM'S BOARD CHAIRMAN RECEIVED UNALLOWABLE COMPENSATION TOTALING \$995,000 **25**

Our audit identified that the Chairman of Spectrum's Board of Trustees received unallowable compensation totaling \$995,000. The payments, which spanned an 11-year period, resulted from a management transition agreement between Spectrum and the Chairman dated December 24, 1991. However, contrary to state regulations, Spectrum was unable to provide any documentation to substantiate that the Chairman, in return for this compensation, provided services that directly benefited Spectrum's state-funded programs. Thus, the Chairman's compensation represents a nonreimbursable cost to the Commonwealth. Additionally, the Chairman received the majority of this compensation while working and residing in Alaska and residing in Florida. Therefore, we question how this individual was able to adequately provide the management services for which Spectrum paid him.

4. SPECTRUM MADE UNALLOWABLE LEASE PAYMENTS TOTALING \$151,532 TO A RELATED PARTY, SPECTRUM DEVELOPMENT CORPORATION, INC. **29**

During the three-year period ended June 30, 2002, Spectrum leased three properties from a related party, Spectrum Development Corporation, Inc. (SDC) that Spectrum used to house several of its Department of Public Health, Department of Social Services, and Department of Correction residential and non-residential programs. However, Spectrum's lease payments exceeded by \$151,532 the allowable limits established by the OSD for payments made to related parties. Therefore, Spectrum owes \$151,532 to the Commonwealth.

5. SPECTRUM USED STATE PROGRAM REVENUES TOTALING \$1,550,444 TO FUND BAD DEBT EXPENSES, EXCESSIVE SALARY PAYMENTS, DEPRECIATION EXPENSES, FUNDRAISING COSTS, AND FREE CARE **32**

Our audit identified that Spectrum used state revenues to fund various nonreimbursable program costs totaling \$1,550,444, including bad debt expenses, excessive salary payments, depreciation expenses, fund raising costs, and free care. These payments, which occurred during the five-year period ended June 30, 2002, violated state regulations and resulted in unnecessary charges to the Commonwealth. Moreover, these violations resulted primarily from Spectrum's improper reporting of investment income on its fiscal year 2002 UFR report financial statements that it submitted to the Commonwealth as well as a technical flaw within the OSD fiscal year 2001 UFR report.

6. SPECTRUM IMPROPERLY UTILIZED STATE PROGRAM REVENUES TOTALING \$1,151,540 TO FUND OUT-OF-STATE PROGRAM LOSSES DURING FISCAL YEARS 1998 AND 1999 **37**

Our audit identified that Spectrum utilized state program revenues totaling \$1,151,540 to fund losses incurred by its out-of-state programs. Spectrum, which primarily serves Massachusetts residents who suffer with substance abuse and domestic violence issues, also operates a Department of Youth Services (DYS) program within the state of Hawaii as well as Department of Correction (DOC) programs within the states of Georgia, North Carolina, and Rhode Island. During fiscal years 1998 and 1999, Spectrum received funding totaling \$4,405,371 for these out-of-state programs, which was virtually limited to Non-Massachusetts State Service Fees. However, during the same period, Spectrum incurred operating expenses within these programs totaling \$5,556,911. Consequently, for the two-year period, Spectrum's combined operating losses for its out-of-state programs totaled \$1,151,540.

7. SPECTRUM IMPROPERLY USED STATE PROGRAM REVENUES TO FUND UNREASONABLE, UNALLOWABLE, AND UNDOCUMENTED TRAVEL EXPENSES TOTALING \$42,695 **41**

Our review indicated that Spectrum used state program revenues totaling \$42,695 to fund unreasonable, unallowable, and undocumented travel costs during fiscal years 2000 through 2002. These unreasonable, unallowable, and undocumented costs resulted from Spectrum's (a) reimbursing the Board Chairman for his commuting costs from Alaska and Florida to attend monthly board meetings, (b) using state funds to help cover the associated travel costs of Spectrum representatives visiting out-of-state programs, and (c) maintaining inadequate supporting documentation for its travel costs. Based upon state program regulations such unreasonable, unallowable, and undocumented costs represent nonreimbursable expenses to the Commonwealth. Consequently, Spectrum owes \$42,695 to the Commonwealth.

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INTRODUCTION

Background

Spectrum Health Systems, Inc., (Spectrum) was incorporated in 1969 as a private, not-for-profit corporation. Presently, Spectrum maintains a full-time staff of more than 800 clinicians, caseworkers, and other professionals who serve adolescents, adults, and criminal justice populations for substance abuse, and mental and behavioral health care needs. Spectrum offers these services at numerous locations throughout central and eastern Massachusetts. Spectrum also provides adolescent services in Hawaii and services for criminal justice populations in Georgia, Illinois, North Carolina, and Rhode Island. Appendix I of this report further details Spectrum's programs and service locations within the Commonwealth.

Spectrum's funding primarily comes from state funds. For fiscal years 2000 through 2002, Spectrum received the following revenues:

Spectrum Health Systems, Inc. Summary of Revenues

<u>Revenue -MA Government</u>	<u>Fiscal Year 2002</u>	<u>Fiscal Year 2001</u>	<u>Fiscal Year 2000</u>
Medicaid	\$9,388,657	\$10,059,679	\$8,185,208
Department of Youth Services	7,303,087	5,684,956	5,106,336
Department of Public Health	5,423,371	5,406,138	4,942,598
Department of Correction	4,026,664	3,989,579	3,643,146
Department of Social Services	1,176,593	269,068	141,571
POS Subcontract	337,613	-	-
Other MA State Agency POS	129,610	391,472	-
MA Government Grant	79,313	219,201	58,812
Department of Education	2,572	68,984	47,053

Other MA Program Revenue

Private Client 3 rd -Party Offsets	\$ 4,087,008	\$ 4,785,105	\$ 1,416,110
Private Client Fees	907,361	809,120	597,641
Local Government	515,527	488,241	964,216
MA Publicly Sponsored Client Offsets	299,609	402,900	474,043
Client Resources	63,405	36,664	51,439

Other Revenue

Out-of-State	\$ 3,339,965	\$ 2,894,351	\$ 2,212,335
Other	720,663	96,406	160,649
Commercial Activities	240,222	135,682	5,017
Private In-Kind	127,689	55,563	45,179
Government In-Kind/Capital Budget	-	58,789	64,186
Investment Revenue	13,528	-	76
Contributions	<u>6,574</u>	<u>91,023</u>	<u>221,770</u>
Total Revenue	<u>\$38,189,031</u>	<u>\$35,942,921</u>	<u>\$28,337,385</u>

Related-Party Relationship

During our audit period, Spectrum maintained a related-party relationship with two entities, Spectrum Development Corporation (SDC) and CiviGenics, Inc. (CiviGenics). The Financial Accounting Standards Board in Statement of Financial Accounting Standards No. 57 (FASB 57) defines such relationships as follows:

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

Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interest.

In November 1983, Spectrum, which was formerly known as Spectrum House, Inc., formed SDC as a not-for-profit corporation under Chapter 180 of the Massachusetts General Laws. According to its Articles of Incorporation, SDC was established for the purpose of holding title to property on behalf of Spectrum House, Inc. Although SDC was created as an independent not-for-profit

agency, it shares a common Board of Trustees with Spectrum, and its real estate transactions are conducted exclusively for Spectrum's benefit. Based upon FASB 57, such common management, common control, and exclusiveness of purpose constitute a related-party relationship.

Additionally, Spectrum maintained a related-party relationship with CiviGenics from October 1995 to June 30, 2002. CiviGenics was organized during 1995 as a for-profit corporation under Chapter 156B of the Massachusetts General Laws. According to its Articles of Organization, CiviGenics was established for the purpose of providing management services to for-profit and not-for-profit organizations and to provide advice and services regarding addiction rehabilitation.

In March 1995, Spectrum's then President founded CiviGenics after expressing concerns to Spectrum's Board of Trustees that "without some radical departure from the present way of doing business Spectrum can only look forward to a shrinking market-share and progressive withering away." In this regard, the President made a series of recommendations that the Board of Trustees unanimously voted to authorize. Moreover, the board authorized the President to take further action consistent with his plan of action, which is provided below as described in the Trustee's meeting minutes dated January 18, 1995:

- *A new for-profit corporation would be created.*
- *This corporation would assume responsibility for the corrections work formerly undertaken by Spectrum.*
- *Spectrum would be a stockholder in the new corporation, the extent of its stock ownership to be determined by an independent evaluation of its current corrections work.*
- *In addition to providing rehabilitation services at correctional facilities, and related business activities, the new corporation will provide management assistance to Spectrum, on a fee basis.*
- *The new corporation would raise the necessary capital to take advantage of the corrections market and otherwise expand those business activities. Hopefully, this will benefit Spectrum by increase in value of its stock ownership in the new corporation.*
- *As part of this arrangement, Spectrum would no longer participate in the corrections rehabilitation market but its work would otherwise remain unchanged. Its Board would remain in place and the new corporation would have a separate and independent Board, reflecting its ownership. [Spectrum's President] would head the new organization and some members of the Spectrum Board would be invited to join the new venture.*

- *The arrangement between the new corporation and Spectrum would be contractual and the management contract between Spectrum and the new corporation would be terminable in the discretion of the Spectrum Board.*

Following the formation of CiviGenics, on May 24, 1995, Spectrum's Board of Trustees awarded CiviGenics a management agreement whereby it engaged CiviGenics as its sole and exclusive managing agent and as an independent contractor to manage, operate, and conduct the business of Spectrum. Under the terms of this agreement, CiviGenics was authorized to perform such duties as are customary for Chief Executive Officers of state contractors comparable in size and demographics to Spectrum, including hiring and terminating personnel, setting compensation, and making all other management decisions consistent with the mission of Spectrum. Moreover, CiviGenics was required to provide full and complete supervision of all Spectrum operations, which included coordination of direct care staff, administration of Spectrum facilities, fiscal administration, planning and development, and personnel administration.

The management agreement took effect on October 12, 1995, at which time Spectrum's President resigned from Spectrum and began managing Spectrum's operations in his new capacity as President of CiviGenics. CiviGenics managed Spectrum's operations until June 30, 2002, during which time CiviGenics greatly influenced the management and operating policies of Spectrum. However, effective July 1, 2002, Spectrum cancelled the CiviGenics management agreement, thus ending a seven-year relationship between the two companies.

During our audit, CiviGenics' President asserted that Spectrum and CiviGenics are not related parties within the meaning of 808 Code of Massachusetts Regulations (CMR) 1.00. However, Spectrum's relationship with CiviGenics clearly represents a related-party relationship as defined by FASB 57, as demonstrated by the following facts:

- The terms of the CiviGenics management agreements with Spectrum for fiscal years 1996 to 2002 enabled the company to significantly influence Spectrum's management and operating policies.
 - For fiscal years 1996 to 2002, CiviGenics's private accountant identified in the annual Notes To Consolidated Financial Statements the related-party relationship between Spectrum and CiviGenics.
 - For fiscal years 1996 to 2002, Spectrum's private accountants identified within Spectrum's annual Notes To Financial Statements the related-party relationship between Spectrum and CiviGenics.
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- Spectrum’s and CiviGenics’s Board of Trustees and Board of Directors, respectively, have maintained at least one common board member since CiviGenics was founded in 1995. In this regard, Spectrum’s Chairman of the Board of Trustees, who was appointed Chairman in January 1992 and continues in that capacity today, served on CiviGenics’s Boards of Directors from March 1995 through April 2002. Moreover, at the time CiviGenics was founded, Spectrum’s Vice-Chairman also served on CiviGenics’ Board of Directors. The Vice-Chairman maintained his dual leadership role until November 28,1995, at which time he resigned from Spectrum’s Board of Trustees.
- At the time that Spectrum’s Board of Trustees awarded CiviGenics its first management agreement, Spectrum acquired an ownership interest in CiviGenics, investing \$500 for 50,000 shares of CiviGenics common stock, which represented approximately 12.5% of the outstanding stock of CiviGenics. Spectrum reported the value of this investment through fiscal year 1997 using the equity accounting method, which is used to determine income derived from a company’s investment in another company over which it exerts significant influence.

Audit Scope, Objectives, and Methodology

The scope of our audit was to examine certain administrative and fiscal activities of Spectrum during the period January 1, 1992 to December 31, 2002. Our audit was conducted in accordance with applicable generally accepted government auditing standards for performance audits and included procedures and tests considered necessary by the Office of the State Auditor (OSA) to meet these standards.

Our objectives consisted of the following:

1. A determination of whether Spectrum has established and implemented adequate and effective management controls, including:
 - Policies and procedures to ensure internal administrative and accounting controls over Spectrum revenues, expenses, and fixed assets;
 - Policies and procedures to ensure that resource use is consistent with laws and regulations; and
 - Policies and procedures to ensure those resources are safeguarded and efficiently used.
2. An assessment of Spectrum’s business practices and its compliance with applicable laws, rules, and regulations as well as the various fiscal requirements of its state contracts.

In order to achieve our audit objectives, we first assessed the system of management controls established and implemented by Spectrum 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 Spectrum's accounting system. The assessment was used in planning and performing our audit tests. We then held discussions with Spectrum officials and reviewed organizational charts and internal policies and procedures. We also reviewed all applicable laws, rules, and regulations. Finally, we examined Spectrum's financial statements, budgets, cost reports, invoices, and other pertinent financial records to determine whether expenses incurred under Spectrum's state contracts were reasonable, allowable, allocable, properly authorized and recorded, and in compliance with all applicable laws, rules, and regulations.

Our review was not made for the purpose of forming an opinion on Spectrum's financial statements. We also did not assess the quality and appropriateness of program services provided by Spectrum through its contracts. Rather, our report was intended to report findings and conclusions regarding Spectrum's compliance with applicable laws, rules, and regulations; the adequacy of Spectrum's performance; and specific processes, methods, and internal controls that could be made more efficient and effective. Additionally, due to the magnitude of the issues we identified at Spectrum (over \$17 million dollars in state resources being misused over an 11-year period), our review of Spectrum's financial activity was limited to the following five areas in order to provide a timely reporting of these issues:

- Spectrum's purchase of a mental health facility from its related party, CiviGenics
- Fiscal years 1996 through 2002 management agreements with CiviGenics
- Fiscal years 2000 through 2002 lease payments to its related party, SDC
- Payments to Spectrum's Chairman of the Board of Trustees from January 1992 through December 2003
- Use of state program resources to fund out-of-state program costs and other nonreimbursable costs

Finally, the OSA is authorized under its enabling legislation, Chapter 11, Section 12, of the General Laws, to perform audits of entities such as Spectrum that contract with the Commonwealth to "determine compliance with the provisions and requirements of such contracts or agreements and the laws of the commonwealth." This statute further mandates that "the state auditor shall have access to such accounts at reasonable times" and that the OSA "may require the production of books, documents, vouchers, and other records relating to any matter within the scope of such

audit.” Additionally, regulations promulgated by the state’s Operational Services Division (OSD), the agency responsible for regulating and overseeing all state contracts awarded to contracted service providers such as Spectrum, require service providers to provide all records needed by the OSA as well as other organizations to complete an audit of the agency. Specifically, 808 CMR 1.04 (8) states:

A Contractor shall make available for review, inspection and audit all records relating to its operations and those of its affiliates, subsidiaries and Related Parties... to any contracting Department, Executive Office, DPS, the Office of the State Auditor, the federal government or their representatives.

During the conduct of our fieldwork, Spectrum provided us with most of the documentation that we requested in a timely manner. At times, Spectrum was unable to supply us with requested documentation because Spectrum (1) did not require its Chairman of the Board of Trustees and its related party, CiviGenics, to provide documents that supported their billing invoices for consulting and management agency services, respectively; (2) had difficulty retrieving some requested pre-1998 documents from its storage facility; and (3) was often unable to obtain other requested information from CiviGenics. Therefore, our ability to perform sufficient audit testing in certain areas was partially impaired, and the audit results and opinions expressed in this report are based solely on the documentation that Spectrum provided to the audit team.

AUDIT RESULTS

1. SPECTRUM PAID EXCESSIVE MANAGEMENT AGENCY FEES TO ITS RELATED PARTY, CIVIGENICS, WHICH RESULTED IN UNALLOWABLE CHARGES TO THE COMMONWEALTH TOTALING APPROXIMATELY \$10.2 MILLION

Our audit identified that Spectrum paid excessive management agency fees to its related party, CiviGenics, which resulted in unallowable charges to the Commonwealth totaling \$10,238,334. Spectrum paid these fees through a series of contracts that it noncompetitively awarded to CiviGenics during fiscal years 1996 through 2002. The purported intent of these contract awards was to reduce Spectrum's management and general operating expenses by sharing common costs (e.g., personnel, rent, equipment lease, and office expenses) with CiviGenics. However, from the onset, Spectrum's Board of Directors allowed CiviGenics' management fee to escalate beyond limits established by the state's Operational Services Division (OSD). This problem persisted through fiscal year 2002, at which time Spectrum discontinued its contractual relationship with CiviGenics and resumed control of its day-to-day administrative operations.

Through state regulation, the state's Operational Services Division (OSD) has limited the amount that the Commonwealth will reimburse state contractors for management agency fees. Specifically, under 808 Code of Massachusetts Regulations (CMR) 1.05(16), OSD defines the following management agency fees as nonreimbursable costs to the Commonwealth:

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

On May 24, 1995, Spectrum signed the first in a series of management agreements with CiviGenics whereby it engaged CiviGenics as its sole and exclusive managing agent. This first agreement specified that CiviGenics had the authority to hire and terminate personnel, set compensation, and make all other management decisions consistent with the mission of Spectrum. Moreover, this agreement required CiviGenics to provide Spectrum with on-site representatives to supervise all Spectrum operations, including (a) direct care staff coordination, (b) planning and development, and (c) fiscal, personnel, and facilities administration. Lastly, CiviGenics was required to fulfill its responsibilities in an efficient manner under the direction and control of Spectrum's Board of Trustees, committees, and officers.

In return for these services, Spectrum agreed to pay CiviGenics a management agency fee of 1% less than the amount that Spectrum had incurred in performing these services during fiscal year 1995. Although this first agreement was signed and dated May 24, 1995, CiviGenics did not begin managing Spectrum's operations until October 15, 1995.

Although Spectrum intended to reduce its management and general operating expenses through its contract with CiviGenics, our audit identified that Spectrum paid CiviGenics an excessive amount during fiscal year 1996 that resulted in unallowable costs to the Commonwealth totaling \$763,535. In this regard, the fiscal year 1995 Uniform Financial Statements and Independent Auditor's Report (UFR) that Spectrum submitted to the Commonwealth identified that the agency paid administrative management and general expenses totaling \$1,203,136 for the period. However, our review indicated that this amount included \$64,897 in nonreimbursable costs and \$183,299 in legal and audit fees, working capital interest, Board of Trustee expenses, and other expenses, which Spectrum would continue to pay during fiscal year 1996 and into the future. Finally, as previously noted, because CiviGenics did not begin managing Spectrum's operations until October 15, 1995, it was entitled to only a prorated share of its fiscal year 1996 management agency fee.

Based upon these adjustments, which are detailed in the table below, Spectrum's management agency fee should have been limited to \$676,412 for fiscal year 1996. Therefore, Spectrum's payments to CiviGenics of \$1,439,947¹ for the period included \$763,535 in unallowable charges, of which Spectrum allocated \$751,902 to its state-funded programs.

¹ This amount includes \$181,863 of management and general expenses which Spectrum misclassified as direct state program expenses on its fiscal year 1996 UFR. Spectrum made similar reporting errors on its fiscal years 1997 through 2000 UFRs totaling \$1,357,200.

Allowable Management Agency Fees

Fiscal Year 1996

<u>1995 UFR Management and General Expenses</u>	<u>UFR Total</u>	<u>Adjusted Amount*</u>	<u>Prorated Amount**</u>
Employee Compensation	\$578,058	\$578,058	\$409,456
Facility Expenses	131,915	131,915	93,439
Leased Program Equipment	2,479	2,479	1,756
Temporary Help	2,355	2,355	1,668
Staff Training	1,463	1,463	1,036
Staff Mileage	37,216	37,216	26,361
Meals	3,767	3,767	2,668
Data Processing	10,917	10,917	7,733
Officers/Directors	11,619	-	-
Legal and Auditing Fees	44,629	-	-
Management Consultant	242,143	242,143	171,517
Administrative Vehicles Expenses	9,524	9,524	6,746
Working Capital Interest	2,922	-	-
Other	<u>124,129</u>	<u>-</u>	<u>-</u>
Subtotals	\$ 1,203,136	\$1,019,837	\$722,380
State Non-Reimbursable Expenses	<u>(64,897)</u>	<u>(64,897)</u>	<u>(45,968)</u>
Total	<u>\$1,138,239</u>	<u>\$ 954,940</u>	<u>\$ 676,412</u>

* Since CiviGenics was not responsible for paying all of Spectrum's management and general expenses, the excluded expenses (e.g., officers and directors, legal and audit, working capital interest, and other expenses) needed to be adjusted in order to determine CiviGenics's allowable management agency fee.

** During fiscal year 1996, CiviGenics managed Spectrum's operations from October 15, 1995 to June 30, 1996. Therefore, CiviGenics was entitled to a management agency fee equal to only 70.833% (8.5 months/12 months) of Spectrum's adjusted fiscal year 1995 management and general expenses.

Following fiscal year 1996, Spectrum agreed to increase the CiviGenics management fee in a manner that violated state regulations and led to Spectrum's charging the Commonwealth an additional \$9,486,432 in unallowable management agency expenses. Specifically, for the six-year period ended June 30, 2002, Spectrum increased the CiviGenics management fees from \$1,439,947 to \$3,744,040, or a 160% increase. Under normal circumstances, a reasonable person would have expected CiviGenics to receive a modest fee increase to compensate it for actual increases in its related management costs (e.g., cost of living raises, additional staffing, inflation). However, increases to Spectrum's management fee were not based upon CiviGenics' relative costs. Rather, Spectrum agreed to provide CiviGenics with additional fees based upon the

annual growth in Spectrum's program revenues. Spectrum agreed to this financial arrangement on March 5, 1998, at which time the two parties executed a revised management agreement that stipulated the following:

Spectrum and CiviGenics agree that the base fee for the management fee due CiviGenics from Spectrum for each fiscal year of 1996, 1997 and 1998 shall be \$1,603,920. This base fee is defined in Article 4 of the management agreement as the sum of account departments 900, 910, 920, and 930 for fiscal year 1995 less 1%. In addition to the said base fee, CiviGenics shall be entitled to receive from Spectrum as an additional management fee compensation for each fiscal year, 10% of any additional revenue generated by Spectrum over the base revenue figure for fiscal year 1995; said base revenue figure for fiscal year 1995 was \$9,939,000.

Since fiscal year 1996 and fiscal year 1997 have passed, the exact amounts due CiviGenics from Spectrum for management fee can be ascertained and said amounts were due and payable by Spectrum to CiviGenics....

This financial arrangement, which remained in effect through fiscal year 2000, resulted in Spectrum's increasing CiviGenics's management fees from \$1,439,947 to \$3,624,512 over the four-year period. Following fiscal year 2000, Spectrum negotiated two final management agreements with CiviGenics whereby it agreed to pay CiviGenics \$3.5 million and \$3,774,040 for services during fiscal years 2001 and 2002, respectively.

Under state regulations, Spectrum is required to maintain adequate documentation to support the payments it made to CiviGenics for management services. In this regard, OSD promulgated 808 CMR 1.04(1), which details for state human service providers the Commonwealth's record keeping requirements, as follows:

Recordkeeping. The contractor and its subcontractors shall keep on file all data necessary to satisfy applicable reporting requirements of the Commonwealth (including DPS, 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....

Despite this regulation, Spectrum did not require CiviGenics to provide detailed documentation supporting the costs it incurred in managing Spectrum's operations. Consequently, Spectrum was unable to provide us with any documentation relative to the actual cost incurred by CiviGenics in managing Spectrum's day-to-day operations or with any cost data to justify the annual increases to CiviGenics's management fees. Thus, in order to reasonably determine the extent to which Spectrum overcharged the Commonwealth for management agency costs, we

applied a 10% annual growth factor to CiviGenics's adjusted base management fee to reflect customary increases in management costs. Based upon this growth factor, we estimate that Spectrum has overcharged the Commonwealth \$10,238,334 for management agency fees, as detailed in the table below.

Schedule of Nonreimbursable Management Agency Fees

Fiscal Years 1996 through 2002

<u>Fiscal Year</u>	<u>Base Management Fee</u>	<u>(10%) Yearly Growth</u>	<u>Allowable Management Fee</u>	<u>Actual Management Fee</u>	<u>Nonreimbursable Amount</u>	<u>Amount Allocated to State Programs</u>
1996 (Adjusted)	\$ 676,412	-	\$ 676,412	\$ 1,439,947	\$ 763,535	\$ 751,902
1997	954,940	\$ 95,494	1,050,434	2,147,309	1,096,875	1,079,688
1998	1,050,434	105,043	1,155,477	2,773,384	1,617,907	1,452,741
1999	1,155,477	115,548	1,271,025	3,342,058	2,071,033	1,859,738
2000	1,271,025	127,102	1,398,127	3,624,512	2,226,385	2,029,052
2001	1,398,127	139,813	1,537,940	3,114,170	1,576,230	1,402,845
2002	<u>1,537,940</u>	<u>153,794</u>	<u>1,691,734</u>	<u>3,744,040</u>	<u>2,052,306</u>	<u>1,662,368</u>
Totals	<u>\$8,044,355</u>	<u>\$736,794</u>	<u>\$8,781,149</u>	<u>\$20,185,420</u>	<u>\$11,404,271</u>	<u>\$10,238,334</u>

As previously noted, Spectrum resumed managing its day-to-day operations beginning in fiscal year 2003. In this regard, Spectrum's President, who was the former Chief Operating Officer of CiviGenics, in a confidential memorandum to the Board of Trustees of Spectrum Health Systems dated February 11, 2002 (see Appendix II), provided the board with reasons to terminate CiviGenics' management contract that included the following:

In the last two fiscal years, FY'00 & FY'01, CiviGenics has played no role in effecting Spectrum's growth. In that time, Spectrum's revenues grew 13% and 21% respectively. This year projects out to approximately 7% growth. However, in that same period of time, the last three fiscal years, the management fee has grown 18%...

At this point, CiviGenics provides no management to Spectrum but rather acts as an outsourcing company that provides accounting, Human Resource support, information technology services and support and proposal development. All of these services could be provided in house by Spectrum at substantially less what [sic] we currently pay CiviGenics.

By terminating the management contract with CiviGenics, we would free up a substantial amount of resources that could be re-invested back into services while still leaving a healthy reserve which will be needed during the expected lean times of the next few years.

Based upon the President's recommendation, Spectrum's Board of Trustees terminated CiviGenics's management agreement effective July 1, 2002. Moreover, since resuming full control over its day-to-day operations, Spectrum has significantly reduced its administrative costs as anticipated by its President. In this regard, Spectrum's management and general costs totaled \$5,200,967 for fiscal year 2002, whereas for fiscal year 2003, Spectrum budgeted only \$3,198,825 for these costs. By operating within this budget, which Spectrum has achieved through February 28, 2003, Spectrum will effectively reduce its total management and general expenses by over \$2 million.

Recommendation

In order to address our concerns relative to this matter, the Commonwealth should recover from Spectrum the \$10,238,334 in unallowable management agency fees that it has charged to the Commonwealth since fiscal year 1996.

Auditee's Response

In response to this audit result, Spectrum stated, in part:

We clearly recognize that in recent years, the organization was disserved by its relationship with its related party management company, CiviGenics, Inc. Spectrum's Board of Trustees, on the recommendation of the CEO, decide that the agreement was not providing any value to the organization and voted to terminate the agreement in February 2002. Spectrum's intent was to return to managing its own affairs internally without outsourcing to CiviGenics and to more efficiently utilize its resources in furthering its charitable mission. Over the period covered by the management agreement, fiscal years 1996 through 2002, CiviGenics developed an inordinate level of excessive control over Spectrum's infrastructure that prevented the organization from terminating the management agreement without duress, hardship and inordinate expense. Faced with the loss of the revenue from Spectrum, CiviGenics made the organization's transition difficult and prolonged. As of this date, Spectrum and CiviGenics are in litigation regarding matters that stem for the period of the management agreement. Potential additional litigation is anticipated against CiviGenics. . . .

During 1995, Spectrum entered into a management agreement with CiviGenics, a related party. As identified in the Report, fees charged to a Contractor "by a management agency which exceed the costs the Contractor would have incurred had it not entered into a management agreement" are non-reimbursable.

During the term of Spectrum's management agreement with CiviGenics, repeated requests were made of CiviGenics by Spectrum's management (as well as by Spectrum's independent auditors) in an effort to obtain documentation to support the amounts billed to Spectrum under the terms of the management agreement. CiviGenics was unresponsive, with the exception of providing basic supporting cost schedules for fiscal

year 1999. The information provided by CiviGenics for 1999 supported the management fees billed. (This documentation was also provided to the Operational Services Division ("OSD") in November 2000.)

Also during the period of the management agreement, the Organization evaluated the management fees being charged for quality of service and for comparison to general and administrative charges being incurred by similar organizations.

Despite CiviGenics' assurances and representations that the management fees were being billed at cost, management of Spectrum became increasingly dissatisfied with management fees charged and in fact, as documented in the Report, terminated the management agreement effective June 30, 2002.

In assessing the reasonableness of the management fees charged, the Report provides for a 10% increase in fees from a base year level. We maintain that such an increase is not consistent with the rate at which Spectrum was growing during this period. Spectrum's revenues increased 280% from 1995 to 2002.

In the absence of Spectrum's ability to obtain supportive cost data from CiviGenics and the contention that a 10% growth rate does not take into account Spectrum's significant growth in size and administrative complexity during the period in question in this response, an alternative methodology was applied to assess the reasonableness of Spectrum's management and general expenses incurred on an annual fiscal year basis from 1996 through 2002.

The methodology proposed by Spectrum was developed as follows:

- Determine the average percentage (on an annual basis from 1996 through 2002) of general and administrative expenses incurred in relation to total revenue generated for similar health and human service providers (by utilizing databases maintained by Guidestar and OSD).
- Calculate Spectrum's allowable general and administrative expenses by applying these percentages to Spectrum's total revenue for the respective year.
- Determine the excessive or non-reimbursable amounts charged as management fees for each year from 1996 through 2002.

Spectrum contends that this methodology fairly reflects the amount of management fees charged for each year from 1996 through 2002. In contrast, the methodology employed by the State Auditor in the Report significantly understates the allowable general and administrative percentages for these years.

As discussed above, in addition to Spectrum's growth in revenues billed and services performed during the period from 1996 through 2002, the Organization's administrative complexity was also increasing.

The following table documents the non-reimbursable amount of Spectrum's general and administrative ("G&A") (including management fees) expenses during the period from 1996 through 2002:

Fiscal Year	Total Revenues	G&A % (1)	Allowable G&A	Actual G&A (2)	Non-Reimbursable G&A
1996	\$ 11,859,692	12.8%	\$ 1,521,598	\$ 2,119,883	\$ (598,285)
1997	15,997,862	12.8%	2,052,526	2,397,944	(345,418)
1998	21,970,327	13.1%	2,886,901	3,334,946	(448,045)
1999	24,630,657	13.0%	3,192,133	3,704,092	(511,959)
2000	28,337,385	12.4%	3,525,715	4,274,346	(748,631)
2001	35,942,241	11.9%	4,281,062	4,355,332	(74,270)
2002	<u>37,624,916</u>	<u>12.2%</u>	<u>4,578,952</u>	<u>5,200,967</u>	<u>(622,015)</u>
	<u>\$176,363,080</u>		<u>\$22,038,887</u>	<u>\$25,387,510</u>	<u>\$(3,348,623)</u>

- *Determined by using industry averages for similar health and human service providers as reported by databases maintained by Guidestar and OSD.*
- *Actual general and administrative expenses charged by Spectrum including all management fees charged by CiviGenics (base management fee as well as amount allocated to Department of Correction Programs . . . It is Spectrum's strong contention that the methodology utilized above is appropriate and fairly illustrates Spectrum's Allowable General and administrative expense for a \$3.7 million organization.*

Auditor's Reply

We agree with Spectrum's statement that the agency was "disserved by its relationship" with CiviGenics and that the reasonableness of the management fees charged by CiviGenics under its management agreement with Spectrum were questionable and inadequately supported.

In its response, Spectrum also acknowledges the fact that the amounts billed by CiviGenics were excessive but takes exception with the methodology used by the audit team in determining the unallowable amounts billed by CiviGenics and reimbursed by Spectrum using state funds. However, we do not agree with Spectrum that our methodology understates the allowable general and administrative percentages for these years. First, as stated in our report, OSD regulations state that any expenses that are not adequately documented are unallowable and nonreimbursable under state contracts. By its own admission, Spectrum was not able to obtain from CiviGenics documentation to substantiate the management fees it was charging to Spectrum.

Consequently, since these expenses are unallowable in accordance with state regulations, we could have reasonably recommended that the Commonwealth seek reimbursement for the entire

\$20,185,420 in undocumented management expenses CiviGenics charged Spectrum during the audit period. However, because we recognize that CiviGenics did provide management services to Spectrum during the audit period, we elected to utilize a reasonable and conservative approach to calculating the excessive amount that Spectrum paid for these services. As stated in our report, according to state regulations, the management fees Spectrum should have paid for these services should not exceed the costs the contractor (Spectrum) would have incurred had it not entered into this management agreement. Given this fact, we took the actual management costs Spectrum incurred prior to entering into its agreement with CiviGenics and then allowed for a significant (10%) annual inflation factor for the entire audit period in order to calculate the allowable amount Spectrum should have paid for these services. Even using this 10% inflation rate, which far exceeded the 2%-3% actual rate of inflation during the audit period, we still calculated that CiviGenics overcharged Spectrum a total of \$10,238,334 for these management services during the audit period.

The analysis of allowable management expenses Spectrum presents in its response is flawed for several reasons. First, as previously noted, the amount of management fees that would be allowable is equal to the actual costs that Spectrum itself would have incurred in providing these services. However, Spectrum's analysis is based not on a projection of its actual costs for providing these services but rather on the average percentage of general and administrative expenses to total revenue for purported similar organizations during the audit period. Since such a percentage would vary significantly between organizations depending on a variety of factors, including their size and the types of programs they operated, an average of these would in no way be reflective of Spectrum's actual service costs.

Moreover, Spectrum could have arrived at a more reasonable allowable cost percentage by applying its methodology to the agency's actual overhead expenses and program revenues. In doing so, Spectrum would have arrived at an allowable administrative cost reimbursement rate of 10.4% for fiscal year 1996 versus the 12.8% suggested within its response. The 10.4% rate is based upon Spectrum's fiscal year 1995 general and allowable administrative costs totaling \$1,138,239, revenues totaling \$9,974,398, and factoring in CiviGenics' contract requirement to provide its management services during fiscal year 1996 at a rate of 1% less than what Spectrum

incurred in providing these services during fiscal year 1995 ($[\$1,138,239/\$9,974,398] - 1\% = 10.4\%$).

Finally, as part of its methodology, Spectrum utilized the average of total general and administrative expenses for similar health and human service providers. However, CiviGenics' fee constituted only a portion of Spectrum's total general and administrative expenses. In fact, throughout the audit period Spectrum continued to pay for overhead costs such as postage, telephone, utilities, etc. Therefore, Spectrum's methodology includes cost factors that are unrelated to CiviGenics's management fees.

It is important to point out that the accuracy and reasonableness of the costs figures we use in our analysis are in fact supported by Spectrum's own budgeted figures. For example, in our report we state that the allowable management fee costs for fiscal year 2002 was \$1,691,734. During fiscal year 2003, Spectrum assumed responsibility for providing these services from CiviGenics and budgeted \$1,653,233 to pay for them, a variance of \$38,501 (approximately only 2%).

2. SPECTRUM'S PURCHASE OF A MENTAL HEALTH FACILITY FROM ITS RELATED PARTY, CIVIGENICS, RESULTED IN \$3.3 MILLION IN UNALLOWABLE AND HIGHLY QUESTIONABLE EXPENSES BEING CHARGED TO THE COMMONWEALTH

On May 31, 2000 Spectrum purchased Boston Road Clinic, Inc., (BRC) and CiviGenics Management Services, Inc., (CMS) from its related party, CiviGenics, for \$3,273,100. Our review of this transaction revealed that the purchase price was unreasonable and inflated because it included \$2,674,917 in goodwill for which Spectrum received no tangible assets. As of June 30, 2003, \$454,736 of this goodwill has been charged to state contracts. Moreover, because Spectrum financed this purchase over a 10-year period, as of December 31, 2002, Spectrum has incurred interest expenses attributable to this goodwill totaling \$233,352. Lastly, although Spectrum has not contracted with the Commonwealth to provide mental health services at BRC, for the two-year period ended June 30, 2002, Spectrum used Commonwealth funds totaling \$2,611,252 to cover operating losses incurred at this clinic. Based upon state regulations, these expenses are unreasonable and non-program-related, and therefore represent nonreimbursable costs to the Commonwealth.

The state's Operational Services Division (OSD) is responsible for regulating and overseeing the activities of all human service providers who contract with the Commonwealth. To this end, OSD has promulgated 808 CMR 1.00, which governs contract compliance, financial reporting, and auditing requirements with which all contracted human service providers must comply. Under 808 CMR 1.05(1) and 1.05(12) OSD defines Unreasonable Costs and Non-Program Expenses as follows:

(1) Unreasonable Costs. Any costs not determined to be Reimbursable Operating Costs as defined in CMR 1.02 or any amount paid for goods or services which is greater than either the market price or the amount paid by comparable Departments or other governmental units within or outside of the Commonwealth.

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

Moreover, under 808 CMR 1.00, OSD has published the Uniform Financial Report Auditor's Compliance Supplement, which provides further guidance for independent auditors to follow when auditing state contractor's financial statements. Regarding reimbursable operating expenses, OSD emphasizes that expenses must be "Costs Incurred in Providing the Contracted or Mandated Services," "Reasonable in Nature," and "Reasonable in Amount." In order to satisfy these criteria, the expense must be (1) ordinary and necessary for the provisions of the particular services that the Commonwealth has agreed to buy, (2) the kind that would be incurred by a prudent person under the circumstances, and (3) the amount that would be incurred by a prudent person.

According to documentation we reviewed, BRC is engaged in the business of providing clinical, psychological, and related services, whereas CMS performs all of BRC's management and administrative functions. For fiscal years 2001 and 2002, BRC received the majority (66%) of its funding, \$4,720,283, through private client third-party payments and private client fees. In addition, BRC received \$1,860,704, or 26% of its operating revenue, through Medicaid and Medicare payments. Finally, as detailed in the chart below, BRC did not receive funding through the Commonwealth's purchase-of-service system.

Summary of BRC Funding

<u>Funding Source</u>	<u>Fiscal Year</u> <u>2001</u>	<u>Fiscal Year</u> <u>2002</u>	<u>Total</u>
Private Client Third-Party Payments	\$2,682,827	\$1,753,747	\$4,436,574
Medicaid	641,499	481,973	1,123,472
Medicare	440,351	296,881	737,232
Private Client Fees	206,446	77,263	283,709
Mass. Government Grant	183,600	95,700	279,300
Commercial Activities	82,545	182,617	265,162
Other	<u>24,488</u>	<u>26,095</u>	<u>50,583</u>
Total Revenue	<u>\$4,261,756</u>	<u>\$2,914,276</u>	<u>\$7,176,032</u>

On May 31, 2000 Spectrum entered into an agreement with its related party, CiviGenics, to purchase the assets of BRC and CMS. Under the terms of this agreement, Spectrum issued a 10-year promissory note to CiviGenics totaling \$2,896,101 that carried an annual interest rate of 6%. Spectrum also agreed to assume \$377,000 of BRC's and CMS's outstanding liabilities, thus raising the effective purchase price to \$3,273,101. In return, as detailed in the table below, Spectrum received BRC's and CMS's assets, which were valued at \$598,183.

BRC and CMS Summary of Assets As of May 31, 2000

<u>Assets Acquired</u>	<u>Amount</u>
Accounts Receivable	\$184,630
Office Equipment	159,801
Leasehold Improvements	114,151
Furniture/Fixtures	55,700
Computer Software	38,981
Cash	18,580
Due To/From CiviGenics	12,856
Prepaid Insurance	7,137
Security Deposit	<u>6,347</u>
Total	<u>\$598,183</u>

During our audit, we reviewed the documentation being maintained by Spectrum relative to this transaction and identified several problems. First, Spectrum could not document how the purchase price for these two companies was determined. Spectrum's President stated that

Spectrum through CiviGenics did not negotiate the price. Rather, CiviGenics stipulated the purchase price based upon an offer it had received from a third party. Moreover, the President said that the third party had previously owned BRC, sold it to CiviGenics during 1998, and had a renewed interest in owning the clinic again. The President, however, could not provide us with any documentation to support his assertion.

Second, we found documentation to substantiate that BRC was experiencing serious operational problems prior to this purchase, yet Spectrum made no attempt to negotiate the purchase price to reflect these problems. In this regard, Spectrum paid a consultant \$5,000 to study the proposed purchase and sale of BRC. The consultant concluded that BRC was a viable going concern that could become profitable within one year and that the sale should proceed as scheduled. However, the consultant also pointed out that BRC had not been properly managed for a number of years, which affected the morale and confidence of the professional staff, employees, payers, patients, and other referring providers. Also, the consultant identified that neither management nor the clinic staff had confidence in the accuracy of the monthly financial statements, especially the revenue numbers. However, per joint instructions from Spectrum and CiviGenics, the consultant's study was not to include a valuation of the purchase price or the quality of the assets and liabilities to be transferred.

Third, and most significant, the difference between Spectrum's effective purchase price, \$3,273,100, and the value of the assets that it received, \$598,183, represents purchased goodwill totaling \$2,674,917. Although goodwill is routinely classified as an asset for accounting purposes and financial statement presentation, the goodwill purchased by Spectrum had no real value at the time since, as the consultant reported, BRC was not a profitable entity and had several management and morale issues.

Presently, Spectrum is amortizing this goodwill over a 10-year period, and for fiscal years 2001 and 2002, Spectrum's amortization expense relative to this transaction, which it charged to state contracts, totaled \$454,736. Additionally, as previously mentioned, Spectrum financed this purchase through a 10-year promissory note with CiviGenics, which it refinanced during December 2001. For the 30-month period ended December 31, 2002, Spectrum incurred interest charges relative to the goodwill totaling \$233,352, which Spectrum charged to state contracts.

Since Spectrum did not receive any value through the purchase of this goodwill at the time, the resulting goodwill expense, \$454,736, and the relative interest costs, \$233,352, are unreasonable costs and not related to the social service purposes of Spectrum's state-funded programs. Thus, these costs represent nonreimbursable expenses to the Commonwealth.

It is important to note again that the consultant hired by Spectrum and CiviGenics to review this purchase concluded that BRC could become profitable within one year. To this end, Spectrum, after acquiring BRC, made various managerial and operational changes to improve the clinic's operating efficiency, including merging BRC's Leominster and Fitchburg sites and eliminating unnecessary mid-level managers. Yet, despite these and other changes, Spectrum has been unable to operate BRC at a break-even point. In fact, for fiscal years 2001 and 2002, BRC experienced losses totaling \$1,388,170 and \$1,223,082, respectively. Spectrum's President stated that he was naive in believing that BRC's costs could be reduced quickly and efficiently enough to make the clinic profitable within just a few years after its purchase.

Because Spectrum did not have unrestricted revenues to offset these losses, it relied upon its surplus state revenues to cover BRC's operating losses. Based upon 808 CMR 1.03 (7), surpluses may be used by contractors for any of its established charitable purposes, provided that no portion of the surplus may be used for any nonreimbursable cost set forth in 808 CMR 1.05, including unreasonable costs and non-program-related expenses. In addition, OSD's Uniform Financial Report Auditor's Compliance Supplement emphasizes that an expense is not reimbursable simply because it satisfies some element of its organization's mission. Rather, the expense must be reasonable in nature and be of the kind that "would be incurred by a prudent person under the circumstances."

Several factors surrounding Spectrum's purchase and operation of BRC reveal that BRC's losses totaling \$2,611,252 are non-program-related expenses that are unreasonable in amount and nature, and thus represent nonreimbursable expenses to the Commonwealth. First, as previously stated, the Commonwealth has not contracted with Spectrum for services at its BRC site. Consequently, the losses incurred by the clinic are not directly related to the social service program purposes of the Commonwealth.

Second, the Commonwealth does not routinely fund losses of this magnitude in programs that serve state clients; therefore, the Commonwealth certainly should not pay for such losses in programs such as BRC's that neither receive state contracts nor serve state clients. In state-funded programs such losses would reflect a contractors' inability to operate within the confines of an agreed-upon program budget. In BRC's case, the losses reflect Spectrum's failure to keep its operating costs in line with its clinical revenue.

Third, as previously reported, Spectrum paid a \$2,674,917 premium (goodwill) for BRC's and CMS's assets despite BRC's operational and financial problems. A prudent person, prior to acquiring such an entity, would have performed adequate due diligence to ensure that the entity could be operated, at a minimum, at a break-even rate; otherwise, the venture could be doomed for failure. Based upon BRC's fiscal year 2001 and 2002 operating results, either Spectrum failed to perform adequate due diligence or BRC's operational and financial problems were much worse than Spectrum believed. In either case, for Spectrum to expect the Commonwealth to pay for its business mistakes relative to a speculative business venture is unreasonable and unjustifiable under any set of circumstances.

In conclusion, given the fact that Spectrum's purchase of BRC and CMS from its related party, CiviGenics, was not an arms-length transaction, the management of these companies had a responsibility to ensure that a fair market price was independently established relative to the transaction. Because both companies failed to do this, they did not meet their fiduciary responsibilities to Spectrum's state funding agencies or to CiviGenics' stockholders. As a result, the purchase price paid by Spectrum was unreasonable and led to unallowable charges to the Commonwealth totaling \$3,299,340 as indicated in the table below:

Fiscal Year	Unallowable Use of State Funds to Pay CRC Expenses	Unallowable Interest**	Unallowable Goodwill*	Total
2001	\$1,388,170	\$122,075	\$238,068	\$1,748,313
2002	1,223,082	83,799	216,668	1,523,549
2003	-	<u>27,478</u>	-	<u>27,478</u>
<u>Total</u>	<u>\$2,611,252</u>	<u>\$233,352</u>	<u>\$454,736</u>	<u>\$3,299,340</u>

* The actual goodwill expenses incurred by Spectrum relative to this purchase totaled \$534,984 or \$267,492 for both fiscal years 2001 and 2002.

** The actual interest expenses incurred by Spectrum relative to this purchase totaled \$335,937 or \$167,836, \$126,590 and \$41,511 during fiscal year 2001, 2002 and 2003 (July through December 2003) respectively.

Recommendation

In order to address our concerns relative to this matter, the Commonwealth should recover from Spectrum \$3,299,340 in unallowable expenses related to goodwill, interest charges, and program losses that it charged to the Commonwealth through December 31, 2002. Also, Spectrum must continue to take appropriate steps to ensure that the Commonwealth is not charged for similar expenses in the future.

Auditee's Response

In response to this audit result, Spectrum provided the following comments:

The Organization notes the following with respect to its purchase of Boston Road Clinic, Inc. ("BRC") from CiviGenics and BRC's operating activities as documented in the Report:

- *Spectrum did not purchase the corporate entity Boston Road Clinic, Inc. but rather acquired some of the assets and assumed some liabilities.*
- *After operating BRC for three years, the Organization now recognizes that the purchase price paid to CiviGenics to acquire BRC was excessive.*
- *BRC generated operating losses of \$2,611,252 for the two-year period ended June 30, 2002.*
- *The facility currently operates at breakeven*

The Organization disputes the following items documented in the Report with respect to BRC:

- *The Organization relied upon Commonwealth surplus revenue retention to fund the operating losses incurred by BRC during the two-year period ended June 30, 2002.*
- *The Organization charged amortization and interest associated with the purchase of BRC to state contracts.*

The Organization has always calculated and reported to OSD the amount of Commonwealth surplus revenue retention derived from Commonwealth of Massachusetts purchasing agencies. Based on these restrictions and the cumulative unrestricted surpluses generated and maintained by the Organization, Spectrum concludes that non-state resources were available to fund the losses incurred by BRC for the two-year period ended June 30, 2002.

Conclusion: As stated above, the mental health service currently operates at breakeven. At no time did Spectrum utilize surplus revenue retention to cover losses at the mental health facility.

Auditor's Reply

In its response, Spectrum acknowledges the fact that it paid an excessive price for Boston Road Clinic (BRC) and that BRC generated operating losses during the first two years of its operation. Given this fact, the \$2,674,917 that Spectrum paid for goodwill is unreasonable and unallowable and the \$454,736 of amortized goodwill expense that Spectrum charged against its state contracts to date is also unallowable. Also, BRC had not operated at a break-even point as of the end of our audit period and in fact, as stated in our report, incurred losses totaling \$1,388,170 and \$1,223,082 in fiscal years 2001 and 2002, respectively.

Spectrum incorrectly contends in its response that it had sufficient non-state revenue to fund the losses incurred by BRC during the audit period. However, as stated in our report, the only surplus funds Spectrum had available were surplus revenues generated by state contracts, and their use is restricted to allowable expenses in state-funded programs, only. Since BRC does not contract with the Commonwealth, any state surplus funds used to fund BRC would be considered a non-program-related expense and therefore unallowable in accordance 808 CMR 1.00. Specifically, under 808 CMR 1.05(1) and 1.05(12), respectively, OSD defines Unreasonable Costs and Non-Program Expenses as follows:

Unreasonable Costs. Any costs not determined to be Reimbursable Operating Costs as defined in CMR 1.02 or any amount paid for goods or services which is greater than either the market price or the amount paid by comparable Departments or other governmental units within or outside of the Commonwealth.

Non-Program Expenses. Expenses of the Contractor, which are not directly related to the social service Program purposes of the Commonwealth.

Moreover, under 808 CMR 1.00, OSD has published the Uniform Financial Report Auditor's Compliance Supplement, which provides further guidance for independent auditors to follow when auditing state contractor's financial statements. Regarding reimbursable operating expenses, OSD emphasizes that expenses must be "Costs Incurred in Providing the Contracted or Mandated Services," "Reasonable in Nature," and "Reasonable in Amount." In order to satisfy these criteria, the expense must be (1) ordinary and necessary for the provisions of the particular services that the Commonwealth has agreed to buy, (2) one that would be incurred by a prudent person under the circumstances, and (3) of an amount that would be incurred by a prudent person. Consequently, the expenses in question do not meet these criteria.

3. SPECTRUM'S BOARD CHAIRMAN RECEIVED UNALLOWABLE COMPENSATION TOTALING \$995,000

Our audit identified that the Chairman of Spectrum's Board of Trustees received unallowable compensation totaling \$995,000. The payments, which spanned an 11-year period, resulted from a management transition agreement between Spectrum and the Chairman dated December 24, 1991. However, contrary to state regulations, Spectrum was unable to provide any documentation to substantiate that the Chairman, in return for this compensation, provided services that directly benefited Spectrum's state-funded programs. Thus, the Chairman's compensation represents a nonreimbursable cost to the Commonwealth. Additionally, the Chairman received the majority of this compensation while working and residing in Alaska and residing in Florida. Therefore, we question how this individual was able to adequately provide the management services for which Spectrum paid him.

The 808 CMR 1.05(10), (12), (18), and (26) promulgated by OSD identifies the following as nonreimbursable costs under state contracts:

(10) Fundraising Expense. The cost of activities which have as their primary purpose the raising of capital or obtaining contributions, including the costs associated with financial campaigns, endowment drives, and solicitation of gifts and bequests. . . .

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

(18) Lobbying Costs. Funds used to compensate or reward lobbyists, consultants or staff to promote, oppose, or influence legislation, or influence the governor's approval or veto thereof or to influence the decision of any member of the Executive branch where such decision concerns legislation or the adoption, defeat, or postponement of a standard, rate, rule or regulation pursuant thereto, and any costs associated with lobbying activities. . . .

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

During our audit, we found that the Chairman's compensation, which Spectrum billed against its state contracts, was not in compliance with these regulations.

On December 24, 1991, Spectrum entered into a Management Transition Agreement (Agreement) whereby the Agency's President, who had served as President for 13 years, was elevated to the titles of Chairman of the Board of Trustees and President Emeritus. Although this Agreement required the Chairman to relinquish his duties as President, Spectrum wanted to

retain the Chairman's services in order to effect an orderly transition of its management and to continue benefiting from services that he "uniquely" provided. In this regard, the Agreement specified that during the period January 2, 1992 to December 31, 1998, the Chairman would continue as an employee of Spectrum for consulting and development services, particularly in regard to maintaining and expanding Spectrum's relationships with donors, contractors, governmental bodies, and trade associations. Additionally, the Agreement provided that the Chairman could engage in other business endeavors, whether as an employee or otherwise, provided such endeavors did not violate an existing non-competition agreement between the parties. In return for his services, Spectrum agree to compensate the Chairman through December 31, 2003 as detailed in the following table.

Schedule of Chairman's Compensation

January 2, 1992 through December 31, 2003

<u>Calendar Year</u>	<u>Compensation</u>	<u>Deferred* Compensation</u>	<u>Annual Payment</u>
1992	\$ 99,000	-	\$ 99,000
1993	168,000	\$ 70,000	98,000
1994	177,000	80,000	97,000
1995	177,000	81,000	96,000
1996	177,000	82,000	95,000
1997	168,000	83,000	85,000
1998	84,000	-	84,000
1999	-	-	83,000
2000	-	-	82,000
2001	-	-	81,000
2002	-	-	80,000
2003			<u>70,000</u>
Totals	<u>\$1,050,000</u>	<u>\$396,000</u>	<u>\$1,050,000**</u>

* The Chairman's deferred compensation for fiscal years 1992 to 1997 was paid during fiscal years 1999 to 2003.

** Spectrum officials informed us that they reduced the amount of compensation paid to the Chairman by \$55,000. Consequently the total amount of compensation paid to the Chairman totaled \$995,000.

In addition to the compensation detailed above, Spectrum also agreed to provide the Chairman with hospitalization and medical insurance, and disability insurance equivalent to that provided to its full-time employees until the earlier of his death or December 31, 2003. Despite our

numerous requests, Spectrum did not provide detailed information necessary for us to ascertain the costs associated with providing these insurance benefits, which were charged to the Commonwealth.

During our audit, we determined that the compensation and fringe benefit package provided to the Chairman violated state regulations and, at a minimum, resulted in unallowable charges to the Commonwealth totaling \$995,000. In this regard, we identified the following factors that clearly demonstrate Spectrum's flagrant violation of state regulations, as well as the Chairman's propensity over time to violate these same regulations for his personal gain.

- Under the Management Transition Agreement, the Chairman was compensated \$995,000 for "consulting and development services particularly in regard to maintaining and expanding Spectrum's relationships with donors, contractors, governmental bodies, and trade associations." Such services represent fundraising and lobbying activities, which are nonreimbursable costs under state regulations.
- In a letter dated February 13, 2003 detailing his understanding of the Management Transition Agreement, the Chairman revealed that his compensation package included a gratuitous payment (bonus) for past employment. Specifically, he wrote, "This Agreement provided compensation to me in the amount of \$105,000 per year for ten years in part as bonus for past employment and for consulting and development services to be performed, particularly in regards to maintaining and expanding Spectrum's relationships with donors, contractors, governmental bodies and trade associations." Under state regulations, such payments are considered non-program-related expenses and thus represent nonreimbursable costs to the Commonwealth.
- During the audit, we requested Spectrum officials to provide supporting documents to substantiate the Chairman's services and to support the \$1,050,000 that it charged to the Commonwealth. However, the invoices supplied by Spectrum officials included the same vague description of services, e.g., "Consulting services for the month of July, 2002." Moreover, each invoice contained the same stamped receipt date, March 19, 2003, which indicates that Spectrum requested this documentation after the fact and solely in response to our audit. Under state regulations, such undocumented expenses are considered nonreimbursable costs to the Commonwealth. (See Appendix IV for an example of the invoices supplied to us by Spectrum.)
- Over the past 10 years, the Chairman has worked and resided in Anchorage, Alaska and resided in Palm Coast, Florida. Consequently, during this period, we question whether the Chairman was able to provide services essential to Spectrum's state-funded programs.

Lastly, as previously mentioned, the Chairman has served as Spectrum's President or Chairman of the Board of Trustees for the past 25- years. During that period, a reasonable person would

expect that the Chairman would have become well-versed in state contract regulations, especially those regulations pertaining to reimbursable program costs. Such knowledge is critical to a service provider's survivability, basic information to a provider's independent auditors, and routinely emphasized at training sessions offered by OSD. Consequently, the Chairman's decision to accept compensation totaling \$995,000 without providing documented, necessary, and program-related services represents not only an abuse of position, but also a waste of taxpayer funds.

Recommendation

In order to address our concerns relative to this matter, we recommend that Spectrum identify the cost of insurance benefits that it provided to the Chairman over the past 11 years. Furthermore, the Commonwealth should recover from Spectrum this amount, as well as the \$995,000, since these expenses represent nonreimbursable costs to the Commonwealth.

Auditee's Response

In response to this audit result, Spectrum provided the following comments:

In 1991, Spectrum entered into a management transition agreement with the Chairman of its Board of Trustees, who also previously served as Spectrum's Chief Executive Officer. The total value of the agreement was \$1,050,000 with payments commencing in 1992.

From 1992 to 1995, Spectrum made payments under the agreement totaling \$390,000. Beginning in 1996 and through 2002, the payments under the agreement were made by CiviGenics.

Spectrum does not challenge the non-reimbursable nature of these costs as presented in the Report. However, it is Spectrum's contention that it is obligated to the Commonwealth for only the amounts funded by Spectrum. . . . Spectrum's obligation is limited to \$390,000. Since this is the amount paid by Spectrum directly.

Auditor's Reply

In its response, CiviGenics acknowledges the non-reimbursable nature of the payments to the Chairman but contends that it should only have to reimburse the \$390,000 that it directly paid to this individual. However, although Spectrum did not directly pay this individual these fees, subsequent to fiscal year 1995, CiviGenics used the state funds that Spectrum paid it for management services to make payments to this individual. In order to accurately report on these issues separately, we did not reduce the allowable management fee expenses we identified in

Audit Result No. 1 by the amount CiviGenics paid the Chairman under their agreement. Consequently, since Spectrum used state contract funds to pay the Chairman the entire \$995,000 in nonreimbursable expenses, it should remit this amount to the Commonwealth

4. SPECTRUM MADE UNALLOWABLE LEASE PAYMENTS TOTALING \$151,532 TO A RELATED PARTY, SPECTRUM DEVELOPMENT CORPORATION, INC.

During the three-year period ended June 30, 2002, Spectrum leased three properties from a related party, Spectrum Development Corporation, Inc. (SDC) that Spectrum used to house several of its Department of Public Health, Department of Social Services, and Department of Correction residential and non-residential programs. However, Spectrum's lease payments exceeded by \$151,532 the allowable limits established by the OSD for payments made to related parties. Therefore, Spectrum owes \$151,532 to the Commonwealth.

In 808 CMR 1.02, OSD has promulgated regulations that define a related party as follows:

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

Moreover, Financial Accounting Standards Board (FASB) Statement No. 57, Related Party Disclosures (AC section R36.406), defines a related party as follows:

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

Another party also is a related party if it can significantly influence the management or operating policies of the transacting parties or if it has an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interest. . . .

In November 1983, Spectrum, which was then known as Spectrum House, Inc., formed SDC in accordance with Chapter 180 of the Massachusetts General Laws. According to its Articles of Incorporation, SDC was established for the purpose of holding title to property on behalf of Spectrum House, Inc. Although SDC was created as an independent nonprofit agency, we

believe that its ongoing activities with Spectrum constitute a related-party relationship as defined by FASB Statement No. 57 for the following reasons:

- Spectrum reported on its fiscal year 2001 Return of Organization Exempt From Income Tax (IRS Form 990) that it was related to SDC through common membership, governing bodies, trustees, officers, etc.
- Spectrum reported on its fiscal year 2001 Public Charities Report, which is filed annually with the State Attorney General, that it leased assets from a related party..
- A private accounting firm reported that Spectrum's fiscal year 2001 financial statements include the activity and balances of both Spectrum and SDC (together, the Organization) after elimination of all material accounts and transactions between the two entities. These entities are affiliated by virtue of common management and common control.
- SDC conducted its activities virtually exclusively with Spectrum during the past three fiscal years. SDC's activities during the period were limited solely to purchasing, renovating, and leasing properties for Spectrum's use.

As a consequence of its related-party relationship with SDC, Spectrum must comply with regulations promulgated by OSD regarding related-party transactions. Specifically, 808 CMR 1.05(8) defines the following costs as being unreasonable and therefore nonreimbursable under state contracts.

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

During our audit we noted that Spectrum violated OSD regulations governing related-party transactions. Specifically, for the three-year period ended June 30, 2002, Spectrum made lease payments to SDC totaling \$597,848, while SDC's cost to own and maintain the facilities for the same period totaled only \$461,783. Additionally, SDC earned interest totaling \$15,467 on overpayments that it received during and prior to our audit period. The difference between SDC's total revenue of \$613,315 and total expenses of \$461,783 represents an unallowable cost of \$151,532 that Spectrum directly charged to the Commonwealth as an occupancy expense under its DPH, DSS, and DOC service contracts. The table below details Spectrum's overpayments to SDC during this three-year period.

Overpayment to Related Party

<u>Allowable Expense</u>	<u>Fiscal Year</u> <u>2000</u>	<u>Fiscal Year</u> <u>2001</u>	<u>Fiscal Year</u> <u>2002</u>	<u>Total</u>
Condominium Fees	\$ 19,760	\$ 22,880	\$ 24,960	\$ 67,600
Building Depreciation	45,237	51,550	51,614	148,401
Interest	63,626	81,393	52,615	197,634
Other	<u>10,728</u>	<u>19,918</u>	<u>17,502</u>	<u>48,148</u>
Total Allowable Expense	<u>\$139,351</u>	<u>\$175,741</u>	<u>\$146,691</u>	<u>\$461,783</u>
Revenue				
Lease Payments	\$183,828	\$207,010	\$207,010	\$597,848
Interest Income	<u>7,316</u>	<u>6,003</u>	<u>2,148</u>	<u>15,467</u>
Total Revenue	<u>\$191,144</u>	<u>\$213,013</u>	<u>\$209,158</u>	<u>\$613,315</u>
Overpayment	<u>\$ 51,793</u>	<u>\$ 37,272</u>	<u>\$ 62,467</u>	<u>\$151,532</u>

Recommendation

In order to address our concerns relative to this matter, the Commonwealth should recover from Spectrum the \$151,532 of unallowable lease payments that it made to its related party, SDC, during fiscal years 2000 through 2002.

Auditee's Response

In response to this audit result, Spectrum provided the following comments:

Spectrum currently leases space for its program operations from Spectrum Development Corporation, Inc. ("SDC"), a related nonprofit organization. Spectrum is aware that Commonwealth regulations limit the allowable costs under such related party agreements to the actual amounts incurred by the related party (in this case SDC).

The Report documents that during the period from 2000 to 2002, Spectrum's lease payments to SDC exceeded SDC's expenses associated with the property by \$200,720.

The primary cause of this disparity is due to SDC establishing Spectrum's rent to match SDC's cash flow needs, specifically, its debt service requirements on an eight-year mortgage note payable underlying the property. However, the related allowable expense is the building's depreciation, which is based on a 40-year useful life.

In addition, the allowable expenses of SDC that are detailed in the Report exclude various other costs incurred by SDC (i.e., insurance, utilities, certain professional fees, etc.) during fiscal years 2000, 2001 and 2002 that appear allowable.

Based upon the above, it is Spectrum's contention that the rent payments made to SDC constitute actual (cash flow) costs of SDC and therefore constitute allowable costs in determining Spectrum's rent payment.

Auditor's Reply

We do not agree with Spectrum's assertion that the rent payments it made to SDC constitute the actual cash flow costs of SDC and hence, are costs that are allocable to state contracts. During our audit, we asked Spectrum officials to provide us with all the documentation relative to SDC's ownership and operation of facilities utilized by Spectrum's state-funded programs. To date, Spectrum has not provided complete detailed costs records for these facilities. Given Spectrum's inability to provide us with the requested documentation, we used its records to the extent possible to identify the expenses being incurred by SDC relative to the operation of the facilities in question. Based on our analysis, we properly determined that Spectrum made unallowable lease payments totaling \$151,532 to SDC during the period under review.

5. SPECTRUM USED STATE PROGRAM REVENUES TOTALING \$1,550,444 TO FUND BAD DEBT EXPENSES, EXCESSIVE SALARY PAYMENTS, DEPRECIATION EXPENSES, FUNDRAISING COSTS, AND FREE CARE

Our audit identified that Spectrum used state revenues to fund various nonreimbursable program costs totaling \$1,550,444, including bad debt expenses, excessive salary payments, depreciation expenses, fund raising costs, and free care. These payments, which occurred during the five-year period ended June 30, 2002, violated state regulations and resulted in unnecessary charges to the Commonwealth. Moreover, these violations resulted primarily from Spectrum's improper reporting of investment income on its fiscal year 2002 UFR report financial statements that it submitted to the Commonwealth as well as a technical flaw within the OSD fiscal year 2001 UFR report.

Under 808 CMR 1.05, OSD identifies expenses that represent nonreimbursable costs to the Commonwealth, including bad debts, certain excessive salaries of officers and managers, certain depreciation expenses, fundraising expenses, and free care, as follows:

***Bad Debts.** Those amounts (whether estimated or actual) which represent the portion of an account or note receivable that proves to be entirely uncollectible despite collection efforts including legal action, and any related legal costs.*

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

Certain Depreciation.

(a) Depreciation for assets to the extent that the assets have previously been depreciated by the Contractor.

(b) Depreciation which is computed by a method other than the following: an historical cost basis with a straight line method; using a schedule of asset service lives pursuant to DPS policy; and charging one half of the annual depreciation expense in each of the years of acquisition and disposal.

(c) Depreciation on idle, excess, or donated assets or on that portion of an asset's historical cost basis, which was paid for from Restricted Funds.

(d) Depreciation on assets acquired under a capital budget approved by a Department and held in trust for the Commonwealth of Massachusetts or depreciation on assets acquired under a capital budget approved by a Department to which the Contractor holds title under the terms of a contract.

Fundraising Expense. The cost of activities which have as their primary purpose the raising of capital or obtaining contributions, including the costs associated with financial campaigns, endowment drives, and solicitation of gifts and bequests...

Free Care. Costs associated with free service and use.

In accordance with the provisions of 808 CMR 1.00, state human service contractors must, on a fiscal year basis, submit a properly completed UFR, which consists of audited basic financial statements, independent auditor's reports, and unaudited supplemental information (schedules, forms, and letters). To assist state contractors fulfill this yearly requirement, OSD has issued a UFR Audit and Preparation Manual. This document, among other things, specifies that non-public sources of revenue such as philanthropic contributions and gifts, federated fundraising, (e.g., United Way), interest income, and commercial revenue may be used to offset nonreimbursable costs. However, this manual prohibits contractors from utilizing state contract funds, state surplus revenue, third-party fees, client resources, client sliding fees, Supplemental Security Income, food stamps, etc., for this purpose.

Moreover, OSD requires contractors to disclose nonreimbursable costs within their annual UFR filing to the Commonwealth, as well as the existence of an appropriate level of non-public sources of revenue to defray their nonreimbursable expenses. These procedures established by OSD attempt to ensure that the Commonwealth does not fund any part of nonreimbursable program expenses.

Despite these rules and regulations, for the five-year period ended June 30, 2002, Spectrum used state surplus revenues and restricted program funds to help defray nonreimbursable costs totaling \$1,550,444. Although Spectrum disclosed these unallowable costs within its applicable UFR filing, the agency did not have sufficient non-public funds to cover the costs. Consequently, Spectrum used funding intended for state clients to cover bad debt expenses, excessive salaries, fundraising costs, and other unallowable expenses. The following table details the extent to which Spectrum used state program revenues to cover its nonreimbursable costs.

Summary of Nonreimbursable Costs*

Fiscal Years 1998 through 2002

<u>Expense</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>Totals</u>
Bad Debts	\$ 554,568	\$ 590,361	\$ 548,700	\$ 449,277	\$ 462,960	\$ 2,605,866
Fundraising	190,374	203,444	77,026	-	-	470,844
Excessive Salary	56,914	59,560	11,594	-	-	128,068
Depreciation	1,978	2,105	2,878	3,102	1,885	11,948
Free Care				<u>106,503</u>	<u>73,811</u>	<u>180,314</u>
Total Expenses	\$ 803,834	\$ 855,470	\$ 640,198	\$ 558,882	\$ 538,656	\$ 3,397,040
Allowable Offset	<u>\$ (343,868)</u>	<u>\$ (237,093)</u>	<u>\$ (401,506)</u>	<u>\$ (432,924)</u>	<u>\$ (431,205)</u>	<u>\$ (1,846,596)</u>
Unallowable Costs	<u>\$ 459,966</u>	<u>\$ 618,377</u>	<u>\$ 238,692</u>	<u>\$ 125,958</u>	<u>\$ 107,451</u>	<u>\$ 1,550,444</u>

* The nonreimbursable costs and non-public revenue attributable to Spectrum's Boston Road Clinic and out-of-state programs are excluded from this table, since Audit Results No. 3 and No. 4 take these nonreimbursable expenses into account.

During this five-year period, Spectrum reported available non-public funds to the Commonwealth that appeared to sufficiently cover its nonreimbursable costs. In this regard, Spectrum's UFRs detailed non-public funds totaling \$4,480,290 and nonreimbursable costs totaling only \$3,397,040. Although Spectrum's figures presented a sound financial picture to the Commonwealth relative to this matter, our review found that Spectrum in fact had only \$1,846,596 available to cover its nonreimbursable costs. Highlighted below are the specific problems we found relative to this matter.

- During fiscal year 2002, Spectrum made a \$2 million lump-sum payment to its related party, CiviGenics. This payment was made relative to a promissory note that Spectrum had issued to CiviGenics for the purchase of BRC (see Audit Result No. 3). In consideration of the lump-sum payment, CiviGenics, as of December 27, 2001, released Spectrum from the balance of the promissory note (\$2,564,115). This transaction

resulted in a \$564,115 savings for Spectrum, which the agency improperly reported as “other income” on its fiscal year 2002 UFR and designated as an offset to its nonreimbursable costs for the fiscal year.

Spectrum’s reporting of this transaction was improper since the \$2 million payment did not generate additional revenue/income for the agency. Rather, the lump-sum payment enabled Spectrum to effectively reduce the purchase price of BRC and thus reduce its future cash outlays relative to the purchase. Therefore, Spectrum should have accounted for this transaction by revaluing BRC’s assets and liabilities instead of artificially inflating its program revenues.

- During fiscal year 2001, Spectrum relied upon private client fees and private client third-party reimbursements totaling \$559,588 to help offset its nonreimbursable costs. However, according to OSD regulations these funds cannot be used to offset an entity’s nonreimbursable expenses.

It should be noted that OSD’s fiscal year 2001 UFR was flawed in that OSD designated client resources, private client fees, and private client third-party reimbursements as allowable offsets to nonreimbursable costs. Although this flaw went undetected by OSD and Spectrum, it does not waive Spectrum’s contractual responsibility to comply with the provisions of 808 CMR 1.00. In this regard, 808 CMR 1.03(3) states the following:

CMR 1.00 Prohibitions. The failure of a Department or DPS [OSD] to identify violations of 808 CMR 1.00 in determining or authorizing a price shall not be deemed a waiver of violations of 808 CMR 1.00 which are identified later.

- During fiscal years 2000, 1999, and 1998, Spectrum did not have sufficient non-public funds to cover its nonreimbursable costs. As the preceding table details, Spectrum’s nonreimbursable costs for these periods exceeded its allowable offsets by \$238,692, \$125,958, and \$107,451, respectively.

In each of these cases, Spectrum overbilled the Commonwealth because it did not have a sufficient amount of non-public funds to defray its nonreimbursable costs. Moreover, Spectrum’s financial shortfall during this five-year period caused it to rely upon \$1,550,444 of state program revenues to fund its non-reimbursable costs.

Recommendation

In order to address our concerns relative to this matter, the Commonwealth should recover from Spectrum the \$1,550,444 in state program revenues that it used to defray nonreimbursable costs over the five-year period.

Auditee's Response

In response to this audit result, Spectrum provided the following comments:

As noted in the Report, the Organization had reported \$2,605,866 of bad debt expense in its UFRs for its fiscal years ended June 30, 1998 through 2002. The Organization has reviewed available documentation for those periods and determined that the majority of these adjustments were contractual allowances and not bad debts.

As detailed in the Operational Services Division's ("OSD") UFR Audit and Preparation Manual, "contractors frequently are involved with contractual allowances and confuse those allowances with bad debts. It is important to recognize the distinction between bad debts and contractual allowances because contractual allowances are not considered non-reimbursable items. Contractual allowances occur frequently in the purchase-of-service ("POS") system. For instance, when fees are charged to a third party for a special service rendered by a contractor to an individual. Contractual allowances should be netted with the revenue when the revenue is recorded at its gross amount and not recorded via an allowance for doubtful accounts as bad debt."

Based upon the above, the Organization has adjusted its UFR's for the fiscal years ended June 30, 1998 through 2002. . . .At no time did Spectrum utilize commonwealth funds to apply for unallowable expenses. Mistakenly filed UFR's do not constitute improper use of state funds.

Auditor's Reply

We note that in its response Spectrum does not take issue with the \$791,174 in excessive salary payments, depreciation, fundraising, and free care expenses that we cite as being unallowable in our report. Therefore, Spectrum should remit these amounts to the appropriate state agencies. Regarding the unallowable bad debt expense, Spectrum claims in its response that these amounts were improperly classified and were in fact, contractual allowances and not bad debt expenses. In its Uniform Financial Reports Audit and Preparation Manual for fiscal year 2002, OSD draws the distinction between bad debt expenses and contractual allowances by stating the following:

Contractual allowances; are frequently recognized by the fact that they were never considered to be a firm or good receivable that carried a legal obligation for payment. Whereas, bad debts are recognized by the fact that there is a legal obligation for payment associated with the bad debt.

Contractual allowances occur frequently in the purchase-of-service (POS) system. For instance, when fees are charged to a third party, i.e., an insurance company for a specific service rendered by a Contractor to an individual. The third party has an agreement to pay a specific price for the service rendered. The Contractor may charge more for that service for various reasons but will only be paid the agreed upon price by the third party. The difference between the gross amount charged by the Contractor and the amount agreed to for a particular service is considered a contractual allowance and not a bad debt.

Accounting for contractual allowances: Contractual allowances should be netted with the revenue when the revenue is recorded at its gross amount and not recorded via an allowance for doubtful accounts as bad debts.

If a receivable is recorded that was never a good receivable, it should be adjusted by crediting the account receivable and debiting the revenue account directly or debiting a contractual allowance account which would be netted with the third-party revenue for financial statement presentation.

Contractual allowances have no effect on the excess revenue over expenses for financial statements when they are properly recorded.

As noted in our report between fiscal years 1998 and 2002, Spectrum charged a total of \$2,605,866 in bad debt expenses against its state contracts. If these were in fact contractual allowances and not bad debt expenses, Spectrum should have complied with OSD guidelines by netting these allowances out of the total revenue and not reporting them on its UFR. By not doing so, Spectrum overstated its revenue by \$2,605,866. Since CiviGenics management fee was based on a percent of Spectrum's revenue, the incorrect accounting of this revenue by Spectrum would have resulted in CiviGenics receiving excessive compensation for management services during these fiscal years. Further, the misrepresenting of this revenue denied state oversight agencies the opportunity to properly monitor the activities of the agency.

Although Spectrum officials contend that these were in fact contractual allowances and not bad debt expenses, to date it has not provided us with any documentation to substantiate this claim. Further, we note that Spectrum made this alleged mistake each year during our audit period of July 1, 1994 through December 2002.

Consequently, we recommend that the Commonwealth recover from Spectrum the \$1,550,444 in state program revenues that it used to defray nonreimbursable costs over the five-year period.

Finally, if during the audit resolution phase Spectrum provides documents to support its claim that bad debts were in fact contractual allowances, then the Commonwealth should make an appropriate adjustment to the amount due from Spectrum.

6. SPECTRUM IMPROPERLY UTILIZED STATE PROGRAM REVENUES TOTALING \$1,151,540 TO FUND OUT-OF-STATE PROGRAM LOSSES DURING FISCAL YEARS 1998 AND 1999

Our audit identified that Spectrum utilized state program revenues totaling \$1,151,540 to fund losses incurred by its out-of-state programs. Spectrum, which primarily serves Massachusetts

residents who suffer with substance abuse and domestic violence issues, also operates a Department of Youth Services (DYS) program within the state of Hawaii as well as Department of Correction (DOC) programs within the states of Georgia, North Carolina, and Rhode Island. During fiscal years 1998 and 1999, Spectrum received funding totaling \$4,405,371 for these out-of-state programs, which was virtually limited to Non-Massachusetts State Service Fees. However, during the same period, Spectrum incurred operating expenses within these programs totaling \$5,556,911. Consequently, for the two-year period, Spectrum's combined operating losses for its out-of-state programs totaled \$1,151,540.

Our audit indicated that, to cover its operating losses, Spectrum improperly used state program revenues, including client fees, retained state surpluses, state contract revenues, and third-party payments. Under 808 CMR 1.00, Spectrum is required to use such resources only to serve Massachusetts residents and to cover operating expenses within its state-funded programs. By using state resources to finance out-of-state program losses, Spectrum displayed a continued unwillingness to safeguard the Commonwealth's assets against loss, waste, and misuse.

Under 808 CMR 1.00, OSD issued the Commonwealth's UFR Audit and Preparation Manual, in which OSD details the appropriate treatment of client fees and third-party payments:

Certain revenues such as client resources or third party payments made on behalf of a client are commonly judged to be unrestricted revenues and available to defray non-reimbursable costs. However, when these revenues are received in a Commonwealth program, they must be used to defray or offset reimbursable operating costs and to reduce the amount of the Commonwealth's obligation for services rendered to the client (pursuant to 808 CMR 1.18, (Effective 2/1/97 808 CMR 1.03(5)). These revenues are commonly referred to as Commonwealth required offsetting revenues (defined in 808 CMR 1.02) to be used for program or invoice offsets.

Based upon Spectrum's fiscal years 1998 and 1999 UFRs, the agency received client fees and third-party payments totaling approximately \$1.9 million and \$1.5 million, respectively. However, contrary to 808 CMR 1.00, Spectrum used \$556,242, or 16%, of this amount to defray operating expenses of its out-of-state programs. During the audit, Spectrum's Fiscal Director acknowledged that these client fees and third-party payments were misapplied but could not provide a further explanation for the violation.

Additionally, during fiscal years 1998 and 1999, Spectrum received four human service contracts from the Massachusetts Department of Public Health that totaled approximately \$8.8 million.

Although these contracts were intended to serve Massachusetts residents with substance abuse and domestic violence issues, Spectrum reallocated \$69,057 of this amount to help fund its programs based in Hawaii, Georgia, North Carolina, and Rhode Island. By subsidizing these out-of-state programs with Commonwealth contract funds, Spectrum directly violated 808 CMR 1.02, which defines reimbursable operating costs as follows:

Reimbursable Operating Costs. Those costs reasonably incurred in providing the services described in the contract . . . Operating costs shall be considered "reasonably incurred" only if they are reasonable and allocable using the standards contained in Federal Office of Management and Budget Circular A-122 or A-21, or successors thereto.

Lastly, Spectrum's fiscal years 1998 and 1999 UFRs identified "realized gains on investments" totaling \$1,102,335, of which Spectrum designated \$1,039,890 as out-of-state program revenue. The reported gain resulted from a revaluation of Spectrum's common stock holdings, 50,000 shares, in its related party, CiviGenics. Specifically, from October 15, 1995 through June 30, 1997, Spectrum utilized the equity method to value this investment. After this date, Spectrum changed to the fair market valuation method, which effectively increased the book value of its holdings from \$22,665 to \$662,500 as of June 30, 1998 and \$1,125,000 as of the close of fiscal year 1999.

However, our audit identified that Spectrum did not actually realize a \$1,102,335 cash gain on its investment, since the 50,000 shares of common stock were not sold, but simply revalued by the agency. Moreover, until Spectrum sells this investment and the proceeds from the sale are designated by Spectrum's Board of Directors to defray program costs, any change in the stocks' computed value must be treated as an unrealized gain/loss on investment and not a source of funds to offset any expenses.

Since unrealized gains do not effectively increase an entity's cash flow, state contractors must identify alternative sources of revenue to offset their program costs. In Spectrum's case, it did not have an allowable alternative source of revenue to help fund its out-of-state-program losses. Consequently, Spectrum improperly used state surplus revenues to help maintain its out-of-state-programs. By doing so, Spectrum violated 808 CMR 1.00, which indicates that state surpluses may not be used for any nonreimbursable cost set forth in 808 CMR 1.05, including unreasonable costs and non-program-related expenses. Since the Commonwealth does not fund

out-of-state programs, Spectrum's use of state surpluses represents an unreasonable cost and a nonreimbursable expense, as defined below.

Unreasonable Costs. Any costs not determined to be Reimbursable Operating Costs as defined in 808 CMR 1.02 or any amount paid for goods or services which is greater than either the market price or the amount paid by comparable Departments or other governmental units within or outside of the Commonwealth.

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

In each instance, Spectrum overbilled the Commonwealth because it failed to identify an allowable source of revenue sufficient to help fund its out-of-state program losses. The table below details the extent to which Spectrum utilized state program resources to offset operating losses within its out-of-state programs during fiscal years 1998 and 1999.

Summary of State Program Resources Used to Cover Out-Of-State Losses

Fiscal Years 1998 and 1999

<u>State Resources</u>	Fiscal Year <u>1998</u>	Fiscal Year <u>1999</u>	<u>Total</u>
Client Fees	\$273,888	\$280,171	\$ 554,059
Retained Surplus Revenues	266,183	260,058	526,241
DPH Contract Revenues	30,354	38,703	69,057
Third-Party Payments	<u>1,315</u>	<u>868</u>	<u>2,183</u>
Total	<u>\$571,740</u>	<u>\$579,800</u>	<u>\$1,151,540</u>

Recommendation

In order to address our concerns relative to this matter, the Commonwealth should recover from Spectrum the \$1,151,540 in state program revenues that it used to offset costs associated with its out-of-state programs.

Auditee's Response

In response to this audit result, Spectrum provided the following comments:

The Report states that \$1,151,540 of losses incurred in out-of-state programs during fiscal years 1998 and 1999 were funded by state program revenues. While the out-of-state programs in question did in fact incur losses during the fiscal years identified, the Organization contends that these losses were funded by its unrestricted net assets, exclusive of Commonwealth surplus revenue retention.

At June 30, 1997, the Organization had unrestricted net assets of \$2,917,565 (net of Commonwealth surplus revenue retention of \$356,518). At June 30, 1998 and 1999, this balance increased to \$4,838,276 (net of \$308,000) and \$6,153,213 (net of (\$353,374)), respectively. . . .Based upon the cumulative unrestricted surpluses generated and maintained by the organization as a whole, prior to and during fiscal years 1998 and 1999, Spectrum concludes that non-state resources were available to fund the losses in its out-of-state programs.

Auditor's Reply

As stated in our report, we found that Spectrum allocated \$1,151,540 in state funds to pay for its out-of-state expenditures. In its response Spectrum contends that it had sufficient unrestricted net assets to pay for the out-of-state program costs in question. However, our review of agency records indicated that Spectrum did not have a sufficient amount of net assets derived from non-Massachusetts state contracts to for these expenses. Consequently, Spectrum owes the \$1,151,540 in out-of-state program costs it improperly charged against its Massachusetts state contracts.

7. SPECTRUM IMPROPERLY USED STATE PROGRAM REVENUES TO FUND UNREASONABLE, UNALLOWABLE, AND UNDOCUMENTED TRAVEL EXPENSES TOTALING \$42,695

Our review indicated that Spectrum used state program revenues totaling \$42,695 to fund unreasonable, unallowable, and undocumented travel costs during fiscal years 2000 through 2002. These unreasonable, unallowable, and undocumented costs resulted from Spectrum's (a) reimbursing the Board Chairman for his commuting costs from Alaska and Florida to attend monthly board meetings, (b) using state funds to help cover the associated travel costs of Spectrum representatives visiting out-of-state programs, and (c) maintaining inadequate supporting documentation for its travel costs. Based upon state program regulations such unreasonable, unallowable, and undocumented costs represent nonreimbursable expenses to the Commonwealth. Consequently, Spectrum owes \$42,695 to the Commonwealth.

a. Unreasonable Travel Costs

The state's OSD has promulgated regulations that specifically identify costs that are nonreimbursable under state contracts. In this regard, 808 CMR 1.05(1) identifies the following as a nonreimbursable cost:

Unreasonable Costs: Any amount paid for goods or services which is greater than either the market price or the amount paid by comparable Departments or other governmental units within or outside of the Commonwealth.

While this state regulation characterizes unreasonable terms of relative costs, federal guidelines, with which Spectrum must comply, define unreasonable costs in a broader context. Specifically, Office of Management and Budget (OMB) Circular A-122 characterizes unreasonable costs as costs “which do not effect the actions a prudent person would take in the circumstances.”

Over the past nine years, Spectrum’s Chairman maintained residency outside of Massachusetts, which has led to the agency’s allocating unreasonable travel costs to its state-funded programs. In this regard, from January 1994 to December 2000, the Chairman lived and worked in Anchorage, Alaska and subsequently relocated to Palm Coast, Florida, where he presently resides. During our three-year audit period, the Chairman commuted to 26 Board of Trustees meetings and incurred associated travel costs totaling \$23,721. Of this amount, Spectrum allocated \$20,901 to its state programs and \$2,820 to its non-state programs. The table below details the Chairman’s travel costs from July 1, 1999 to June 30, 2002.

**Spectrum Health Systems, Inc.
Summary of Chairman’s Commuting Costs
Fiscal Years 2000 through 2002**

<u>Fiscal Year</u>	<u>Air Fare</u>	<u>Meals</u>	<u>Hotel</u>	<u>Auto Rental</u>	<u>Misc.</u>	<u>Total</u>	<u>State Allocation</u>
2000	\$ 3,111	\$163	\$1,937	\$ 780	\$ 228	\$ 6,219	\$ 5,535
2001	7,507	180	4,229	2,271	682	14,869	13,234
2002	<u>1,496</u>	<u>90</u>	<u>106</u>	<u>128</u>	<u>813</u>	<u>2,633</u>	<u>2,132</u>
Total	<u>\$12,114</u>	<u>\$433</u>	<u>\$6,272</u>	<u>\$3,179</u>	<u>\$1,723</u>	<u>\$23,721</u>	<u>\$20,901</u>

Had Spectrum used individuals from within the Commonwealth to serve on its board, as is the case with the vast majority of the human service organizations that the Office of the State Auditor has audited, it would not have incurred the \$20,901 in unreasonable board-related commuting costs. Moreover, these funds would then have been available to provide needed services to Spectrum’s consumers.

b. Unallowable Travel Costs

In 808 CMR 1.05(12), OSD has promulgated regulations that specifically identify non-program-related expenses as nonreimbursable costs under state contracts, as follows:

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

During our audit, we found that Spectrum officials and representatives visited the agency's out-of-state programs located in Hawaii and Georgia and traveled to California, Colorado, and New Jersey in an effort to expand the agency's operations through program acquisitions and corporate mergers. In total, Spectrum officials made 18 out-of-state trips during fiscal years 2000 through 2002. These trips cost \$23,187, including the cost of airfares, hotels, meals, and other miscellaneous expense. Although these trips did not benefit the Commonwealth in any manner, Spectrum nevertheless allocated \$20,523 of the total costs to its state-funded programs. Consequently, Spectrum violated OSD's regulations governing non-program-related expenses. The table below details the \$20,523 in non-program-related travel expenses that Spectrum inappropriately charged to the Commonwealth during the three-year period ended June 30, 2002.

**Spectrum Health Systems, Inc.
Summary of Non-Program-Related Travel Expenses
Fiscal Years 2000 through 2002**

<u>Fiscal Year</u>	<u>Hawaii</u>	<u>Georgia</u>	<u>California</u>	<u>Colorado</u>	<u>New Jersey</u>	<u>Total</u>	<u>State Allocation</u>
2000	\$ 2,505	-	\$ 6,959	\$ 550	\$1,154	\$11,168	\$ 9,939
2001	7,589	-	3,018	-	-	10,607	9,440
2002	<u>853</u>	<u>\$559</u>	<u> </u>	<u> </u>	<u> </u>	<u>1,412</u>	<u>1,144</u>
Total	<u>\$10,947</u>	<u>\$559</u>	<u>\$9,977</u>	<u>\$550</u>	<u>\$1,154</u>	<u>\$23,187</u>	<u>\$ 20,523</u>

c. Undocumented Travel Costs

OSD has promulgated regulations that specifically identify undocumented expenses as nonreimbursable costs under state contracts. Specifically, 808 CMR 1.05(26) defines undocumented expenses as follows:

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.

In addition to the unreasonable and unallowable travel expenses noted above, we also identified that Spectrum, in some instances, did not maintain adequate supporting documentation for its travel costs. Specifically, for fiscal years 2000 through 2002, Spectrum allocated \$1,271 of travel expenses to its state-funded programs for which the agency did not have any travel records on file to substantiate the charges.

Recommendation

In order to address our concerns relative to this matter, the Commonwealth should recover from Spectrum the \$42,695 in unreasonable, unallowable, and undocumented travel costs that Spectrum charged to Commonwealth programs.

Auditee's Response

In response to this audit result, Spectrum provided the following comments:

The Report identified \$42,695 of unallowable travel expenses incurred during fiscal years 2000 through 2002. Spectrum does not challenge the non-reimbursable nature of these costs. . . .

APPENDIX I

**Spectrum Health Systems, Inc.
State Program Services and Service Locations**

<u>Service Location</u>	<u>Substance Abuse & Mental Health Outpatient Services</u>	<u>Adolescent Services</u>	<u>Women's Services</u>	<u>Correctional Recovery Academy</u>	<u>Transitional Services</u>	<u>Addiction Center</u>	<u>Reintegration Services</u>	<u>Assessment Center</u>	<u>Family Services</u>	<u>First Step</u>	<u>Residential Services</u>	<u>Detox. & Rehab. Services</u>	<u>Community Resource Center</u>	<u>Psych. & Counseling Services</u>
Boston	Yes	Yes	Yes	Yes	Yes									
Bridgewater				Yes	Yes	Yes	Yes							
Charlestown		Yes												
Chelsea		Yes												
Concord				Yes	Yes		Yes	Yes						
Dorchester		Yes												
Fitchburg														Yes
Framingham		Yes		Yes	Yes				Yes	Yes				
Gardner	Yes			Yes	Yes									
Hingham											Yes			
Lancaster				Yes	Yes		Yes		Yes					
Leominster	Yes											Yes		
Lowell													Yes	
Lynn		Yes	Yes											
Methuen		Yes												
Milford	Yes													
Norfolk				Yes	Yes									
Plymouth				Yes	Yes		Yes							
Quincy	Yes													
Roxbury			Yes											
Shirley	Yes				Yes		Yes							
Walpole					Yes									
Webster		Yes												
Westboro	Yes										Yes	Yes		
Worcester	Yes	Yes											Yes	Yes

APPENDIX II**Spectrum Health Systems, Inc.****President's Recommendation to Terminate CiviGenics Management Contract****Confidential Memo to the Board of Trustees of Spectrum Health Systems**

Charles J. Faris, President/CEO
February 11, 2002

Spectrum entered into a management contract with CiviGenics, Inc. in May of 1995. The intent was to provide management services for Spectrum, which included all business management functions, quality improvement, accreditation, human resource functions, proposal development and senior leadership. Additionally, there was a mandate to effect growth of Spectrum's services in both depth and breadth while assuring a positive net surplus at the end of each year. Spectrum received a common stock equity position in CiviGenics of approximately 3.8%. The hope at the time was that CiviGenics would grow successfully and eventually go public or be acquired and Spectrum's equity position would yield a substantial return that could be used as the basis for an endowment for the organization. CiviGenics would receive 1 % less than Spectrum's management expenses at that time, FY'95 with provisions going forward for a percent of the gross that exceeded the cost of management in FY'95.

The contract was amended January 1, 1996.

In the last two fiscal years, FY'00 & FY'01, CiviGenics has played no role in effecting Spectrum's growth. In that time, Spectrum's revenues grew 13% and 21 respectively. This year projects out to approximately 7% growth. However in that same period of time, the last three fiscal years, the management fee has grown 18%.

CiviGenics, while financially healthy, has leveled off in their growth and has been stagnant. There is no opportunity that an IPO will be offered thus, eliminating the hope that the equity position will translate into a windfall basis for an endowment. The affiliation with CiviGenics through the management agreement no longer brings any added value to Spectrum.

Over the last two years Spectrum has reinvested in the organization to build a management infrastructure to guide the organization through the next several years. The expense of this management team is over and above the management fee paid to CiviGenics. At this point, CiviGenics provides no management to Spectrum but rather acts as an outsourcing company that provides accounting, Human Resource support, information technology services and support and proposal development. All of these services could be provided in house by Spectrum at substantially less what we currently pay CiviGenics.

By terminating the management contract with CiviGenics, we would free up a substantial amount of resources that could be re-invested back into services while-still leaving a healthy reserve which will be needed during the expected lean times of the next few years.

APPENDIX III

Spectrum Health Systems, Inc.

Example of CiviGenics Billing Invoice/Department of Correction

CIVIGENICS, INC		INVOICE	
100 LOCKE DRIVE MARLBORO, MA 01752 (508) 303 - 6878 Ext.107		Number: <u>500</u> <i>B</i> Date: <u>05/31/99</u>	
BILLED TO:			
SPECTRUM HEALTH SYSTEMS, INC. 100 LOCKE DRIVE MARLBORO, MA 01752			
** Terms: Payable Upon Receipt **			
SERVICES FOR THE PERIOD OF:	May 1999		50,000.00
SERVICES RENDERED:			
DOC MANAGEMENT, ACCOUNTING, FINANCIAL, PAYROLL, AND HUMAN RESOURCES.			50,000.00
LESS YEAR TO DATE CREDIT ADJUSTMENT			-2214.08
TOTAL DUE			<u>\$47,785.92</u>
VENDOR <u>SPEC</u>			
GL ACC	<u>001-205000</u>		
DATE	<u>5/28</u>		
INVOICE			
VOUCHER	<u>18757</u>		

APPENDIX IV

Spectrum Health Systems, Inc.

Example of Chairman's Billing Invoice

July 31, 2002

INVOICE
Invoice #9673 MAR 19 2003

ROBERT P. GALEA, Ph.D.
17 Eagle Harbor Trail
Palm Coast, FL 32164

VENDOR: ROBGAL/

Bill to:
Spectrum Health Systems, Inc.
324 Grove Street
Worcester, MA 01605

VENDOR R. Galea SPECTRUM
GL ACCT #: 001-74452050
DIST. DATE: MAR 24 2003
INVOICE #: _____
VOUCHER: 60247

ATTENTION: Janet Langlois

Description:

Consulting services for the month of July, 2002.

AMOUNT

\$ 6,250.00

TOTAL \$ 6,250.00

001-2050