



January 24, 2013

Mr. Kevin McClure  
Chief Financial Officer  
Northwestern Human Services, Inc.  
620 Germantown Pike  
Lafayette Hills, Pennsylvania 19444

Dear Mr. McClure:

I am enclosing the final report of Northwestern Human Services, Inc. Cost Allocation Plan that was recently completed by this office. Your response has been incorporated into the final report and labeled as Appendix A.

I would like to extend my appreciation for all the courtesy extended to my staff during the course of fieldwork. I understand that you were especially helpful to Barbara Miller in expediting the audit process.

The final report will be processed by the Office of Administration's (OA) Audit Resolution Section. The staff from the OA may be in contact with you to follow-up on the action taken to comply with the report's recommendations.

If you have any questions concerning this matter, please contact David Bryan, Audit Resolution Section, at (717) 783-7217.

Sincerely,

A handwritten signature in black ink that reads "Tina L Long". The signature is written in a cursive, flowing style.

Tina L. Long, CPA  
Director

Enclosure

c: Ms. Karen Deklinski  
Ms. Angela Logan

bc: Mr. Alexander Matolyak  
Mr. Daniel Higgins  
Mr. David Bryan  
Ms. Kenya Mann Faulkner  
Ms. Shelley Lawrence  
SEFO Audit File (S1010-Z99)

Some information has been redacted from this audit report. The redaction is indicated by magic marker highlight. If you want to request an unredacted copy of this audit report, you should submit a written Right to Know Law (RTKL) request to DPW's RTKL Office. The request should identify the audit report and ask for an unredacted copy. The RTKL Office will consider your request and respond in accordance with the RTKL (65 P.S. §§ 67.101 et seq.) The DPW RTKL Office can be contacted by email at: [ra-dpwtkl@pa.gov](mailto:ra-dpwtkl@pa.gov).



January 24, 2013

The Honorable Gary Alexander  
 Secretary for the Department of Public Welfare  
 Health and Welfare Building, Room 333  
 Harrisburg, Pennsylvania 17120

Dear Secretary Alexander:

In an effort to understand how Northwestern Human Services, Inc (NHS) distributes its administrative costs to the various programs it provides, the Bureau of Financial Operations (BFO) initiated an audit of the NHS cost allocation plan (CAP) for the fiscal year ended June 30, 2010. The audit addressed the CAP's methodology as well as the propriety of the costs included in the administrative cost pool.

This report is currently in final form and therefore does contain NHS's views on the reported findings, conclusions and recommendations. Management's response to the draft report is included as an appendix hereto. The report's contents were discussed at an exit conference held on November 28, 2012.

**Executive Summary**

NHS is one of the largest providers in Pennsylvania, providing services across the state to several Program Offices including the Office of Mental Health and Substance Abuse Services (OMHSAS), Office of Developmental Programs (ODP), the Office of Children, Youth and Families (OCYF), and Adult Residential Living (ARL). NHS is primarily a not-for-profit agency, but also operates for-profit subsidiaries which do not provide direct services. For the fiscal year ended June 30, 2010, NHS reported total revenue of \$490,133,300 and administered 652 program sites.

The report findings and recommendations for corrective action are summarized below:

FINDINGS	SUMMARY
<p><b><i>Finding No. 1 - Pension Expense Related To Executive Management Staff Is Excessive.</i></b></p>	<p>All NHS employees are provided the opportunity to participate in a 403B pension plan.</p> <p>In addition, nine executive level management staff are provided with opportunity to participate in a second pension plan. The cost of this additional pension plan is \$537,045.</p>

**HIGHLIGHTS OF RECOMMENDATIONS**

DPW should:

- Recover \$500,365, the amount allocated to DPW programs, pertaining to the executive pension plan.
- Take steps to ensure this cost is not included in future administrative cost pools.

NHS should:

- Charge the cost associated with the executive pension plan to NHS's Unallocable Cost Center.

**FINDINGS**

***Finding No. 2 - Legal Costs***

**SUMMARY**

NSH included in the Administrative Cost Pool, costs associated with legal fees related to a suit filed against the Commonwealth. The suit was filed to force the Commonwealth to release Federal funds during a budget impasse. The total amount related to this suit was \$314,474.

**HIGHLIGHTS OF RECOMMENDATIONS**

DPW should:

- Recover the total amount of \$314,474 related to the suit filed against the Commonwealth.

NHS should:

- Refrain from including such cost within its administrative cost pool.

**FINDINGS**

***Fining No. 3 - Costs Identified As Unallowable***

**SUMMARY**

NSH included in its Administrative Cost Pool inappropriate expenses related to Country Club fees and alcoholic beverages. Additionally, certain bank fees were accrued in excess of the actual amount and never adjusted to expense the correct amount. Total questioned costs are \$7,167.

NHS has controls in place to prevent such expenses from being charged; however, these items were an oversight.

**HIGHLIGHTS OF RECOMMENDATIONS**

DPW should:

- Recover the \$7,167 identified as unallowable costs.

NHS should:

- Review its internal control procedures to ensure inappropriate expenses are not included with reimbursable expenses items.
- Ensure accrued expenses are reconciled to the actual amount.

OBSERVATION	SUMMARY
<b><i>Observation - Salaries Paid To Executive Management Staff Averaged \$279,208.</i></b>	NHS identified 18 executive level management staff whose average compensation amounted to \$279,208 in salary and bonuses, exclusive of fringe benefits.  DPW does not have guidelines and/or regulations pertaining to maximum financial participation for remuneration in all programs.

### **Background**

NHS provides services in Pennsylvania, New Jersey, Delaware, Maryland and Virginia. Services provided in Pennsylvania span numerous program offices including ODP, OCYF, OMHSAS, and ARL, and comprised 93% of NHS's total business. NHS is primarily a not-for-profit provider. In addition to its corporate headquarters, located in [REDACTED], Pennsylvania, NHS has two regional offices to oversee costs associated with programs in the Eastern region and those in the Central/Western regions of Pennsylvania. Administrative costs allocated to the various programs served consist of costs related to corporate operations as well as regional operations.

Corporate costs are accumulated within a cost allocation pool consisting of 18 cost centers. Corporate costs are then allocated based on several methodologies as deemed appropriate for the cost center which is being allocated. The following details the methodologies used and the associated cost center(s).

Direct Cost Methodology – this statistic allocates cost based on a ratio of each entity's percentage of actual cost to total cost. The cost centers using this statistic are: Executive, Chief Operating Officer, Administration, Financing, Corporate Accountability, Controller, Internal Audit, and Communications.

Revenue Methodology – this statistic allocates cost based on a ratio of each entity's percentage of actual revenue to total revenue. The cost centers using this statistic are: Business Operations, Intellectual Developmental Disabilities Brand Management, Children's Services Brand Management, and Adult Behavioral Brand Management.

Number of Email Users Methodology – this statistic allocates cost based on a ratio of each entities number of email users to total email users. The cost center using this statistic is the Information Technologies Department.

Number of NHS Employees – this statistic allocates each entities number of employees to total employees. The cost center using this statistic is the Human Resources Department.

Number of NHS Employees (Excluding AVS) – this statistic allocates cost based on a ratio of each entities number of employees to total employees excluding Allegheny Valley School employees. The cost center using this statistic is the Payroll Department.

Accounts Payable Transactions Methodology - this statistic allocates cost based on the number of accounts payable transaction processed for each entity. The cost center using this statistic is the Accounts Payable/Purchasing Department.

Total Insurance Premiums – this statistic allocates costs based on the actual insurance premiums of each entity. The cost center using this statistic is the Insurance Department.

Square Footage – this statistic allocates costs based on the square footage of each entity. The cost center using this statistic is the Facilities and Construction Department.

Expenses NHS determines unallowable for federal and state participation are compiled in an unallocable cost center and excluded from CAP costs.

The criterion used to assess NHS's CAP was the Federal Office of Management and Budget (OMB) Circular A-122 and applicable Department of Public Welfare (DPW) regulations, policies and procedures. Also, the majority of individuals served receive funding under various Federal programs. As such, applicable Federal regulations were applied.

The Code of Federal Regulation (CFR) Title 42 Public Health, Part 430 Grants To States For Medical Assistance Programs states, "Within broad Federal rules, each State decides eligible groups, types and range of services, payment levels for services, and administrative and operating procedures." (42. CFR 430.0) Also the CFRs establish the basis for OMB Circular A-87 Cost Principals for a State, Local and Indian Tribal Governments and OMB Circular A-122 Cost Principals for Non-Profit Organizations (2.CFR 225.5 & 2.CFR 230.5).

OMB Circular A-87 states, "Governmental units assume responsibility for administering Federal funds in a manner consistent with underlying agreements, program objectives, and the terms and conditions of the Federal award." OMB Circular A-87 further defines a "Government unit" as an entire state, local, or federally recognized Indian tribal government.

OMB Circular A-122 states within the General Principles, "Reasonable Cost. A cost is reasonable if in its nature or amount, it does not exceed that which would be incurred by a prudent person..."

The above Federal provisions were applied to determine allowable expenses.

### **Objective/Scope/Methodology**

The audit objective, developed in concurrence with the DPW Office of Administration was:

- To determine whether indirect costs are equitably allocated to all benefiting entities and to ensure indirect costs included in the cost pool are eligible for cost reimbursement.

In pursuing this objective, the BFO interviewed NHS management staff, reviewed the general ledger, payroll records, and various other supporting documents necessary to pursue the audit objective. Additionally, the BFO reviewed each allocation methodology, and tested the amounts charged various programs to ensure the proper amount was allocated as detailed in the CAP.

Government auditing standards require that we obtain an understanding of management controls that are relevant to the audit objective described above. The applicable controls were examined to the extent necessary to provide reasonable assurance of the effectiveness of these controls. Based on our understanding of the controls, no material deficiencies came to our attention. Areas where we noted an opportunity for improvement in management controls are addressed in the findings of this report.

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

The BFO's fieldwork was conducted intermittently from June 22, 2011 to September 19, 2011 and was performed in accordance with generally accepted government auditing standards. This report is available for public inspection.

### **Results of Fieldwork**

The NHS CAP distributes costs accumulated in 18 cost centers related to corporate operations based on the various allocation methodologies described in the Background section above. These corporate costs are distributed to 23 benefiting divisions.

Once the corporate costs are allocated to a particular division, the programs within that division receive a share of the corporate cost based on an allocation methodology of program cost to total division cost. Additionally, each division receives a share of its regional administrative costs which are separate from corporate administrative costs. Regional administrative costs are allocated to each program based on cost to total cost. BFO did not test costs included in the regional cost allocation pools but, did verify the methodology used to allocate the cost.

The BFO tested the corporate allocation methodologies as well as the appropriateness of the costs included in the cost pool. Based on our audit, it appears the methodologies used and the costs included are reasonable, appropriate and equitably distributed with the exceptions noted below.

### **Finding No. 1 – Pension Expense Related To Executive Management Staff Is Excessive.**

NHS offers a 403B pension plan to all staff, including executive management staff. The 403B pension plan includes a contribution limitation based on a maximum salary amount. As such, NHS provides a second pension plan. This second 457 pension plan is exclusively for executive management staff.

Management stated that this additional plan is offered so as not to penalize staff whose salary exceeds the limit established by the 403B plan. For fiscal year ended June 30, 2010 NHS paid a total of \$537,045 related to the 457 plan for nine executive management staff.

The 55 Pa. Code 4300.83(f) states the DPW will participate in benefits which are formally established and consistently applied. NHS has more than 10,000 employees agency wide, and the 457 pension plan is offered to only nine employees. Additionally, the 55 Pa. Code 3170 (47) (f), governing Children, Youth and Family programs states, in part, that "...the county agency shall adhere to prevailing county practice... Policies shall be submitted in writing for review by the Department..." Federal provisions (The Provider Reimbursement Manual part 1, Section 2141.3) also require that a deferred compensation plan be offered to all eligible employees; and, no provision of the plan may discriminate in favor of certain employees, e.g., employees who are stockholders, supervisors, or highly paid personnel. Furthermore, OMB Circular A-122 provides that costs must be reasonable and that a provider must minimize its cost and not exceed what a prudent and cost conscious buyer pays for a given item or service.

The cost of the pension plan is in addition to the salaries received by the nine executive management staff and is 93% funded by DPW. These nine individuals' collective salary and bonus was \$2,864,779, as such; a second pension expense of \$537,045 could be considered excessive and not applied consistently to all employees.

**Recommendations:**

The BFO recommends the DPW recover \$500,365 paid to reimburse NHS for the 457 pension plan<sup>1</sup>. Additionally, the DPW needs to take steps to ensure this cost is not included in future administrative cost pools and allocated to all programs.

The BFO further recommends NHS charge the costs related to the 457 plan to its unallocable cost center, therefore removing the cost from those costs reimbursed with taxpayer dollars.

**Finding No. 2 – Legal Costs**

Included in Legal Costs were two invoices totaling \$314,474. Management stated that those invoices represented legal services related to litigation against the Commonwealth during the budget impasse in 2009. The suit was filed to attempt to force the Commonwealth to release Federal funds while the budget negotiations were still ongoing. Management further stated that this suit was settled and never went to court.

55 Pa. Code 6211.72 (e) (2) only permit reimbursement of legal costs related to suits against the Commonwealth if the provider prevails in the suit. Moreover, inclusion of these legal costs could not be considered reasonable under OMB Circular A-122.

**Recommendations:**

The BFO recommends the DPW recover the \$314,474 paid for legal services related to the law suit filed against the Commonwealth.

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<sup>1</sup> Amount of recovery adjusted to reflect the amount paid by the Pennsylvania Department of Public Welfare.

### **Finding No. 3 – Costs Identified As Unallowable**

NHS has internal controls and procedures in place to review expenses and properly allocate them to the appropriate cost center and account; however, our review identified some inappropriate expenses which were included in the administrative cost pool. The following expenses should not have been included in NHS' cost allocation pool in accordance with OMB Circular A-122:

- Country Club Fees – Fees totaling \$190 related to country club expenses for the Executive Director were charged to the administrative cost pool.
- Alcoholic Beverages – Restaurant bar charges including alcoholic beverages were included with employee expense reimbursements. Total amount identified \$377.
- Additionally, certain bank fees were accrued at \$800 per month, when the actual annual charge was only \$3,000. No reversing entry or credit related to this accrual was identified in the General Ledger resulting in excess bank fees of \$6,600.

Management stated that they block certain types of establishments from the corporate credit cards in an attempt to limit inappropriate use; however, the charges related to alcoholic beverages were included with restaurant charges and were not excluded when reviewing employee expense statements. As such, these items were an oversight and an exception to NHS policies.

#### **Recommendations:**

The BFO recommends the DPW recover the total \$7,167 related to inappropriate expenditures and excess bank fees.

The BFO also recommends that NHS review its internal control procedures to ensure that inappropriate expenses are not included with reimbursable expense items, and that expense accruals are reconciled to actual cost.

#### **Observation – Salaries Paid To Executive Management Staff Averaged \$279,208.**

NHS has identified 18 staff as Executive or Upper Level Management who received average salary and bonus of \$279,208 for the fiscal year ended June 30, 2010. These salaries were charged out to all the programs, without adjustment, through the administrative cost pool.

Our review of the regulations and restrictions applicable to certain NHS programs and services identified the following as being directed to salaries: 55 Pa. Code 4300.83, and 55 Pa. Code 6211.73 (a) place limits as to maximum salary participation. Further, OMB Circular A-122 requires both direct and indirect costs of providers' services to be reasonable. The Provider Reimbursement Manual Part 1 (HIM 15), section 2102.1 (Reasonable Cost) state, "Implicit in the intention that actual costs be paid to the extent they are reasonable is the expectation that the provider seeks to minimize its cost and that its actual costs do not exceed what a prudent and cost conscious buyer pays for a given item or service."

In evaluating the reasonableness of the executive salaries, a prudent evaluation must consider the size and complexity of the NHS operation and the multitude of services it provides. Only two of the programs provided by NHS and funded by the DPW have included guidelines within the program specific regulations that establish reasonable salaries to determine compensation costs eligible for

Department participation. We do note that an application of the above-referenced regulations, applicable only to the ICF/ID programs, would set the maximum level for salary and fringes for the Executive Director, the highest level, at \$178,354 for the fiscal year ended June 30, 2010. However, since most of the NHS programs receive some Federal funding we believe the reasonableness concept referenced in the OMB is applicable to the NHS executive salaries. These salaries are charged out to all programs as part of the corporate administrative cost pool. As a result, the average salaries of executive management staff would have exceeded the maximum participation level established for the highest level salary permissible in ICF/ID programs.

NHS allocated management salaries to all the respective programs applicable to NHS's business, which is a practice not unique to NHS. However, not all DPW programs have regulations or policies in place that would define compensation costs eligible for Department participation. Accordingly, it would appear appropriate for all DPW programs to consider the use of consistent guidelines in identifying the maximum amount that will be considered for financial participation across all relevant program areas. In consideration of programs like NHS, that provide a multitude of services, DPW should consider implementing a universal rule that would, at a minimum, establish the maximum salary in which DPW will participate.

#### **Exit Conference / Auditors Commentary**

On November 28, 2012 an exit conference was held at NHS's administrative offices. In attendance were NHS management, NHS legal counsel and the BFO audit staff. At the exit conference the audit report along with NHS's response was discussed.

NHS representatives stated that they acknowledge the cost reasonableness principal as described in OMB Circular A-122, but contend that the reasonableness principal was misapplied by the auditors. In particular, NHS asserts that their size and scope of programs administered warrants fringe benefits such as the second executive management pension in order to attract the most qualified personnel. They also assert that the lawsuit against the Commonwealth of Pennsylvania pertaining to the budget impasse of 2009 was necessary and led to the budget settlement. It is, therefore, their position that NHS prevailed in the suit.

The BFO believes the cost reasonableness principal was correctly applied and that the cost of the second executive pension and the suit against the Commonwealth do not fit the definition of reasonable costs. As such, no changes were made to the draft report. Finally, we noted two inaccuracies in NHS's response: first, executive salaries were included as a component of the CAP audit since executive salaries are allocated costs; and second, the auditors were never presented with the Watson Wyatt compensation report.

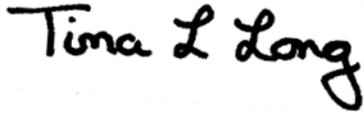
In accordance with our established procedures, an audit response matrix will be provided to the Office of Administration since several program offices are impacted. The Office of Administration will be responsible for completing the matrix and forwarding it to the DPW Audit Resolution Section within 60 days at:

[RA-pwauditresolution@pa.gov](mailto:RA-pwauditresolution@pa.gov)

Northwestern Human Services, Inc.  
July 1, 2009 to June 30, 2010

The response to each recommendation should indicate the Office of Administration's concurrence or non-concurrence, the corrective action to be taken, the staff responsible for the corrective action, the expected date that the corrective action will be completed, and any related comments.

Sincerely,

A handwritten signature in black ink that reads "Tina L Long". The signature is written in a cursive, slightly slanted style.

Tina L. Long, CPA  
Director

Attachment

c: Ms. Karen Deklinski  
Ms. Angela Logan

bc: Mr. Alexander Matolyak  
Mr. Daniel Higgins  
Mr. David Bryan  
Ms. Kenya Mann Faulkner  
Ms. Shelley Lawrence  
SEFO Audit File (S1010-Z99)

**NORTHWESTERN HUMAN SERVICES, INC.  
RESPONSE TO THE DRAFT REPORT**

**APPENDIX A**



Mr. Daniel Higgins  
Audit Manager  
Division of Audit and Review  
Bureau of Financial Operations  
Department of Public Welfare  
801 Market Street, Suite 5040  
Philadelphia, PA 19107-3126

Re: Draft BFO Audit Report: Allocation and Allowability of  
NHS Administrative Costs

Dear Mr. Higgins:

I am counsel to and am writing on behalf of NHS Human Services in response to the Findings and Recommendations set forth in a Draft Audit Report ("Report") prepared by the Bureau of Financial Operations ("BFO"), Department of Public Welfare ("Department"), that BFO recently forwarded to NHS. The purpose of the audit, according to the Report, was as follows:

In an effort to understand how Northwestern Human Services, Inc. (NHS) distributes its administrative costs to the various programs it provides, the Bureau of Financial Operations (BFO) initiated an audit of the NHS cost allocation plan (CAP) for the fiscal year ended June 30, 2010. The audit addressed the CAP's methodology as well as the propriety of the costs included in the administrative cost pool.

The Report also described the "audit objective," developed "in concurrence with the DPW Office of Administration," as follows:

To determine whether indirect costs are equitability (sic) allocated to all benefitting entities and to ensure indirect costs included in the cost pool are eligible for cost reimbursement.

As noted in the Report, the auditors' fieldwork "was conducted intermittently from June 22, 2011 thru September 19, 2011.

After interviewing NHS staff and completing a thorough review of NHS' books and records, the auditors concluded that the NHS CAP is in compliance with OMB Circular A-122 and that there are "no material deficiencies" in the NHS management controls that are relevant to the audit objective. The auditors further determined that in testing the NHS corporate allocation methodologies and the appropriateness of costs incurred in NHS cost centers, the "methodologies used and the costs included are reasonable, appropriate and equitably distributed" except for three areas of costs identified in the Report. See Report at 5. Our response to the specific audit Findings and Recommendations and to an auditor's "Observation" is set forth below.

#### BACKGROUND

NHS is the largest non-profit provider of community based human services in the United States. The company and its 10,500 employees, who work in 27 non-profit subsidiary companies, care for and serve 50,000 adults, adolescents and children in seven States in areas such as behavioral health, intellectual/developmental disabilities, autism, education, juvenile justice, therapeutic family care and addictive diseases. The company and each of its subsidiary companies are highly regulated and must maintain strict compliance with federal statutes and regulations that govern the provision of and payment for the types of services listed above in addition to the specific and varied statutes and regulations of the various states in which they operate relating to licensing standards, employee qualification, care and service provision, service and payment documentation, record keeping and life safety standards. Like Pennsylvania, the other states in which NHS operates have their counterparts to BFO and the federal government too imposes stringent regulatory enforcement over NHS activities. (See too, for example, the Medicaid Integrity Program [42 U.S.C. § 1396 u-6], that, via performance audits conducted by private contractors, ensures that provider claims for services rendered are paid in accordance with applicable regulatory requirements and are properly documented.)

#### DISCUSSION

The Report identifies the Federal Government's OMB Circular A-122 ("A-122") and purportedly applicable Department regulations, policies and procedures as the criteria BFO relied upon to assess the NHS CAP. In particular, the Report, at p. 4, refers to the "General Principles" contained in A-122 and how they define a "reasonable cost" as one that "in its nature or amount, it does not exceed that which would be incurred by a prudent person . . . ." Given the auditors' reliance on the definition of "reasonable cost," NHS incorporates the definition in its entirety to avoid any uncertainty or confusion regarding the term:

Reasonable costs. A cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the costs. The question of the reasonableness of specific costs must be scrutinized with particular care in connection with organizations or separate divisions thereof which receive the preponderance of their support from awards made by Federal agencies. In determining the reasonableness of a given cost, consideration shall be given to:

- a. Whether the cost is of a type generally recognized as ordinary and necessary for the operation of the organization or the performance of the award.
- b. The restraints or requirements imposed by such factors as generally accepted sound business practices, arms length bargaining, Federal and State laws and regulations, and terms and conditions of the award.
- c. Whether the individuals concerned acted with prudence in the circumstances, considering their responsibilities to the organization, its members, employees, and clients, the public at large, and the Federal Government.
- d. Significant deviations from the established practices of the organization which may unjustifiably increase the award costs.

The Report contains three "Findings and Recommendations" regarding the allowability of certain administrative costs incurred by NHS and a general "Observation" directed not to NHS but to the Department's management. Regrettably, our response to the Findings and Recommendations is unnecessarily and unfairly impeded by the lack of cogent explanation in support of the Report's Findings and Recommendations. Instead, we are confronted with partial reference to regulations that generally are inapplicable in their entirety to the costs in dispute and to mere conclusions and inferences relating to the applicability of the provisions of A-122 to the costs at issue. Indeed, the Observation itself plainly concedes the lack of specific regulatory support by the Department for the proposed Findings and Recommendations. Nonetheless, the

Report, without either legal or policy justification, proceeds to apply conceded inapplicable regulations and to misapply A-122 to the disputed pension costs. We explain below our concerns and objections to the Findings, Recommendations and Observation.

Finding No. 1 - Pension Expense Related to Executive Management Staff is Excessive.

The Report alleges that the “457 pension plan” created for nine NHS executive management staff (separate from a plan available to all NHS employees) at a cost of \$537,045 “could be considered excessive and [is] not applied consistently to all employees” and thus recommends that the Department recover over \$500,000 from NHS. (emphasis added.) Draft Report at 6. In support of the Finding, the Report references two Departmental regulations, the Medicare Provider Reimbursement Manual, and A-122. Otherwise, however, the Finding provides scant explanation and no analysis whatsoever regarding the applicability of these several provisions to the NHS pension plan. We address each of the relied on provisions in turn.

(a) The Report cites to 55 Pa. Code § 4300.83(f) for the proposition that the Department participates in “benefits which are formally established and consistently applied” which the NHS plan, according to the Report, apparently is not. The Chapter 4300 regulations, adopted in 1987, specify standards applied by county mental health and mental retardation programs to pay providers of service. See 55 Pa. Code §§ 4300.1-2. Unmentioned in the Report is that with the adoption and implementation of the HealthChoices Program throughout Pennsylvania, the vast majority of funding for behavioral health services provided to eligible clients is a matter of contract between providers such as NHS and managed care corporations. County programs now are largely uninvolved from a payment perspective. Likewise, practically all funding for services provided by NHS to intellectually and developmentally disabled persons comes not from the counties but from the Department’s Consolidated and Person/Family Directed Waiver Programs. Indeed, the Department long ago announced that the Chapter 4300 regulations do not apply to waiver program funded services. Thus, the reference to and reliance on this regulation is materially flawed and misplaced. Although the regulation relied on by BFO does not technically apply to the pension costs at issue here, NHS has, as the regulation provides, “formally established and consistently applied” its pension payment policies. In any event, the fact that NHS maintains two pension plans is neither uncommon among large non-profit corporations nor impermissible under the plain language of the referenced, if inapplicable, regulation.

(b) The Report next refers to 55 Pa. Code § 3170.47(f) as “governing Children, Youth and Family programs” and how it provides that “the county agency shall adhere to prevailing county practice . . . .” Actually, Chapter 3170 does not apply to providers of service but, instead, to county children and youth agencies. The plain terms of the regulation itself state how the

“county agency shall adhere to prevailing county practice.” (emphasis added.) The Report does not explain how or why this regulation is even applicable to this audit Finding.

(c) The Medicare Provider Reimbursement Manual is applicable to the Medicare Program and is not applicable to the programs operated and administered by NHS. The Report otherwise is silent regarding the relevance of the Manual to the costs in dispute here. Also, the Report fails to explain how the provisions of the Manual apply to the terms of the 457 pension plan.

(d) A-122 is referenced in the Report for the proposition that a provider’s “costs must be reasonable and that a provider must minimize its costs and not exceed what a prudent and cost conscious buyer pays for a given item or service.” Draft Report at 6. According to the Report, the expenses incurred by NHS relating to the pension plan for its executive level managers “could be considered excessive” because the plan is “in addition to the salaries received by the nine executive management staff” and is predominantly funded by the Department.

Other than advancing an “opinion” regarding the “reasonableness” of the costs of the 457 pension plan, the Report, having raised A-122 as an applicable standard, notably, and erroneously, fails to give any consideration to and fails to actually apply the elements that the Circular requires to be taken into account when determining the “reasonableness” of a given cost. Supra at p. 2.

A fair application of the elements of the Circular’s definition of reasonable cost to the 457 pension plan in the context of the pervasive regulatory environment that envelops NHS and its subsidiary organizations, together with the nature, scope and size of their operations, indisputably demonstrates that the costs of the plan are reasonable for NHS to incur as part of its fiduciary responsibility to retain and recruit senior managers who possess the requisite experience, acumen and commitment essential to the continuing success of the organization. The NHS executive managers ultimately are responsible for and accountable to 50,000 at risk consumers, their families, and federal and state oversight agencies and for sustaining and enhancing the quality and competency of the NHS workforce. The 457 pension plan is a compensation benefit that recognizes the nature and demands of their day-to-day responsibilities.

Intentionally or not, in reaching a contrary conclusion, the Report fails to reference the compensation studies conducted by independent benefit advisors to NHS who, in developing the 457 pension plan, relied on the latest available compensation levels, practices and policies among organizations similar to NHS in size and scope as reported by [REDACTED] NHS, of course, shared these studies with the auditors. The Report’s failure to even consider such independent, national compensation benchmarks is sufficient basis alone to invalidate the Report’s Finding and Recommendation.

Finding No. 2 - Legal Costs.

In the summer of 2009, NHS filed a lawsuit against ██████████ to compel state officials to release millions of dollars in payments undisputedly owed to NHS as of ██████████ for a range of human services, including secure and non-secure child welfare services provided to adjudicated dependent and delinquent youth and for specialized foster care treatment programs provided to children with behavioral and emotional problems. The impetus for the litigation was the unlawful decision by state government officials, in response to the undue delay in passage of the Commonwealth's annual appropriation act for the 2009-2010 fiscal year, to release payments to providers of certain types of human service programs but not to providers of all human service programs such as child welfare services, autism intervention programs, community mental health and drug and alcohol services. Instead, state officials mandated the providers of those services to maintain their 100% government funded programs without any payment from the Commonwealth pending the formal passage and adoption of the State's 2009-2010 budget.

After the passage of 60 days with no payment and, equally disconcerting, little likelihood of prompt receipt of payment in the foreseeable future, NHS, consistent with its fiduciary obligation to protect its clients and to manage its resources responsibly and effectively, authorized the initiation of litigation against ██████████ to secure payment for services mandated by the Commonwealth to be provided to children and adults under the care of NHS.

Counsel for NHS prepared and filed a Complaint and Request for Preliminary Injunction in federal court asserting, inter alia, violation of the rights of NHS to due process and equal protection under law and violation of applicable federal and state statutes. Prior to the preliminary injunction hearing, which counsel, of necessity, prepared for, the Commonwealth adopted the FY 2009-2010 appropriation act thus resolving the litigation in the favor of NHS.

In support of its recommendation that the legal costs are unallowable, the Report, at p. 6, relies on 55 Pa. Code § 6211.72(e)(2) for the proposition that a provider may claim its legal costs relating to suits against ██████████ "if the provider prevails in the suit." Applying the regulation as if it were a universal standard, the auditors neglect, unsurprisingly, to mention how the regulation is expressly limited to payments made to providers of intermediate care facility services to persons with intellectual disabilities. See generally 55 Pa. Code Chapter 6211. (The regulation itself specifies allowable administrative costs and allows "legal costs, including attorney's fees if the provider prevails.") Although we assert that the costs comport with the regulation, the fact is that the costs at issue were unrelated to ICF/ID services and payments and, accordingly, this regulation is irrelevant to this Finding.

Apart from the odd and erroneous application of the ICF/ID regulation, the only other justification cited for this Finding is as follows:

Moreover, inclusion of these legal costs could not be considered reasonable under OMB Circular A-122.

The lack of cogent analysis and explanation for this assertion denies NHS any meaningful notice of the basis for the Finding and related Recommendation. More than a year has passed since the audit was completed and this single sentence is the basis for a recommended disallowance of substantial costs reasonably incurred by NHS. Just why are the legal costs “not considered reasonable” under A-122? What analysis did the auditors conduct to support that conclusion?

Notwithstanding the lack of meaningful explanation for the Finding, and for future reference, Attachment B to A-122 lists the principles “to be applied in establishing the allowability of certain items of cost.” Attachment B, at paragraph 10, references the prosecution of civil proceedings by providers and expressly authorizes coverage of the costs associated thereto. Suffice to say, given the extended passage of time without payment and the continuing obligation to maintain services, and with no certainty as to when payments would resume, NHS acted reasonably and responsibly in pursuing its available legal remedies to compel the release of payments owed by the Commonwealth.

#### Finding No. 3 - Costs Identified As Unallowable.

NHS agrees that the expenses (amounting to \$7,167.00) identified in this Finding are unallowable and has returned the funds to the Department. Consequently, the Finding is moot and should be withdrawn.

#### Observation - Executive Salaries

In an audit report that is intended to focus on the allocation and allowability of certain administrative costs incurred by NHS, the Report, without apparent authorization, indulges in commentary regarding the salaries of NHS executive management staff.

The Report does so despite its acknowledgements that executive salaries were not part of the audit. For that reason, the Report’s pronouncements must be regarded as mere surplusage and the Observation should be withdrawn.

The Department has engaged outside consultants [REDACTED] to address the issue of executive compensation for non-profit providers that render services to participants in programs



Mr. Daniel Higgins

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funded by the Department. To date, the Department has declined to adopt, let alone publish, the results of the consultants' findings and recommendations. To the extent that BFO seeks to insert itself into such policy discussions within the Department, it certainly may attempt to do so. For it to reach out and opine, sua sponte, on the matter within an audit involving a single provider is improvident and unnecessary and BFO should refrain from venturing into a policy matter that the Department, as noted, has reviewed but remains undecided about.

NHS looks forward to meeting with you to discuss these matters. We ask that prior to the meeting you apprise us of any rebuttal to our responses to the Report's Findings, Recommendations and Observation.



JAK/sas

cc: Kevin McClure, Chief Financial Officer, NHS

