COMMONWEALTH OF PENNSYLVANIA
DEPARTMENT OF PUBLIC WELFARE
BUREAU OF FINANCIAL OPERATIONS
Room 525 Health and Welfare Building
Harrisburg, Pennsylvania 17105-2675

MAY 19 2010

KEVIN M. FRIEL
DIRECTOR

TELEPHONE NUMBER
(717) 772-2231
FAX NUMBER
(717)705-9094

Mr. Regis Champ
President/CEO
Allegheny Valley School
1996 Ewings Mill Road
Coraopolis, Pennsylvania 15109

Dear Mr. Champ:

Enclosed is the final audit report of Allegheny Valley School recently completed by this office. Your Agency's response has been incorporated into the final report and labeled Appendix A.

The final report will be forwarded to the Department's Office of Development Programs (ODP) to begin the Department's resolution process concerning the report contents. The staff from that office may be in contact with you to follow up on the corrective action actually taken to comply with the report's recommendations.

I would like to express my appreciation for the courtesy and cooperation extended to the DAR staff during the course of the fieldwork.

If you have any questions concerning this matter, please contact Mr. Michael J. Kiely, Audit Manager of the Western Field Office, at (412) 565-2187.

Sincerely,

Kevin M Friel

Kevin M. Friel

Enclosure

c: Mr. Casey
Mr. Stauffer
Mr. Kelley
Mr. Ryan
Mr. Church

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.

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DEPARTMENT OF PUBLIC WELFARE
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ROOM 525 HEALTH & WELFARE BUILDING
HARRISBURG, PA 17105-2675

KEVIN M. FRIEL
DIRECTOR

TELEPHONE
(717) 772-2231
FAX
(717) 705-9094

MAY 19 2010

Mr. Kevin T. Casey, Director
Office of Developmental Programs
502 Health and Welfare Building
Harrisburg, Pennsylvania 17120

Dear Mr. Casey:

The Bureau of Financial Operations (BFO) has conducted an audit of Allegheny Valley School (AVS). The audit was performed at the request of the Department of Public Welfare (DPW) Audit Committee in response to the May 2008 merger between AVS and Northwest Human Services, Inc. (NHS) and the related deferred compensation and accrued leave payout made to AVS' President/CEO.

A draft of this report was reviewed by AVS and their comments, which are identified as Appendix A, are attached to this report. AVS elected not to have an exit conference. In the response attached AVS agrees with the auditor's interpretation of the regulations and calculations for Issue Number one. The AVS response further proposes actions that AVS believes will relieve the need to return the $905,806 that has been questioned. In response the BFO reviewed the regulations and has concluded that the alternative action offered by AVS is not provided for in the regulations.

Executive Summary

Results of Fieldwork	SUMMARY
President/CEO Deferred Compensation and Accrued Leave Payout	• Concurrent with exploring the potential merger or sale of AVS the Board revised the President/CEO's employment contract on May 29, 2007, establishing a deferred compensation plan. • AVS' agreement to merge with NHS constituted a "Change in Control" that required fully funding the deferred compensation plan and triggered a "Good Reason Severance Payment" provision. • The "Good Reason Severance Payment" provision entitled the President/CEO to a total payout of $3,648,049.
Effect of merger on FY 08/09 and FY 09/10 AVS rates	• Acquisition resulted in a net cost increase to AVS through assessment by NHS of a management fee of $1,782,857 for FY 08/09. • The management fee for FY 09/10 increased over the previous year by $2,450,116 for a total increase of $4,232,973. • Interest expense was reduced by approximately $500,000 annually through the refinancing of AVS long term debt.

ISSUE	SUMMARY
Issue No. 1 – Investment Income Earned on Funded Depreciation Used to Fund the President/CEO Severance Payment Must Be Applied to Reduce Allowable Interest Expense	• Assets from a funded depreciation account were the primary source used to fund the President/CEO deferred compensation package. • The Medicare Provider Reimbursement Manual (HIM-15) requires that when assets from such accounts are used for other than acquisition of depreciable assets, loans to the general fund or other specific capital purposes, investment income from the account shall be used to reduce allowable interest expense. • The assets used to fund the deferred compensation/severance package included investment income of $905,806 that should have been used to reduce allowable interest expense.

HIGHLIGHTS OF RECOMMENDATIONS
ODP should ensure $905,806 of investment income is applied to offset allowable interest expense in all AVS cost reporting periods subject to reopening.

ISSUE	SUMMARY
Issue No. 2 – Erroneous Allocation of 2008 Bond Interest Expense, Amortization of Issuance Costs and Related Fees Resulted in Excess AVS Expense of $6,591 for FY 07/08 and $63,056 for FY 08/09	• NHS-AVS issued $54 million in revenue bonds as part of the purchase of AVS. $27 Million was paid to the AVS Foundation for purchase of their membership interest and $27 million was used to refinance existing AVS debt. • Based on the transaction, 50% of the bond interest, related fees and amortization of issuance costs should be allocated to AVS. • NHS erroneously allocated 52.58% of these expenses to AVS.

HIGHLIGHTS OF RECOMMENDATIONS
ODP should reduce AVS' allowable 2008 bond issue interest expense, amortization of issuance costs and bond related fees by $6,591 and $63,065 in the audit settlements for FYs 07/08 and 08/09 respectively. ODP should also ensure subsequent fiscal year cost reports reflect the appropriate allocation.

Background

AVS is a private 501 (c) (3) non-profit corporation operating residential and therapeutic programs for individuals with intellectual disabilities. For the fiscal year ended June 30, 2008, AVS' independent audit indicated total revenues of $116,348,718, with 82% of this total coming from Medical Assistance and 12% from county mental retardation programs.

Prior to May 30, 2008, AVS was controlled by AVS Foundation (Foundation). On May 30, 2008, AVS was acquired by NHS-AVS, LLC, a wholly owned subsidiary of NHS, Inc. As sole member, NHS-AVS holds controlling financial interest in AVS. The sequence of events that led to this acquisition is as follows:

- A special meeting of the AVS Board held on May 2, 2007. At the meeting concerns were raised as to the corporation's ability to continue to perform its mission in the future as well as it had in the past. Discussion centered on the state of the industry, increased government regulations, difficulty in attracting and retaining qualified management staff, long outstanding waiver appeals and audit receivables, and the company's financial position resulting from increased borrowings to cover receivables and expansion. According to the AVS President/CEO, these concerns had been discussed in the past and the Board had discussed the possibility of liquidating AVS. Following discussion, the Board unanimously adopted a resolution authorizing the CEO to explore the potential merger or sale of AVS with or to a like organization. The objective of a sale or merger would be to create a much larger company that would be better positioned, fiscally and operationally, to carry out AVS' mission into the foreseeable future. The Board also passed a resolution that a consultant be retained to assist in identifying potential suitors.

- At a special meeting of the Board on October 19, 2007, members were informed that AVS' consultant identified nine prospective buyers. Several of them toured the facility however only one, NHS, submitted an offer to purchase AVS. The initial offer was rejected, but through negotiations an agreement was reached. The Board resolved that it was in the best interest of AVS to proceed with a transaction with NHS, subject to certain conditions and authorized the Vice Chair and President/CEO to negotiate a definitive agreement containing all the terms and conditions of the sale. The Board further resolved that AVS seek to include as a condition of the sale an agreement that NHS retain the AVS senior management team, offering them comparable positions with comparable compensation and benefits.

- At the December 12, 2007 regular meeting, the Board approved establishing the Foundation, a 509(a)(3) organization, which is defined by the Internal Revenue Service as a supporting organization for a public-supported charity. Through an amendment to the AVS bylaws, it was then established as the sole corporate member of AVS. Previously these rights and interests vested with individual corporate members selected by the AVS Board. The Board also approved the transfer of all funds constituting the AVS Endowment Fund including intellectual property known as the "Terrible Towel" along with rights to future royalties, to the Foundation.

- At a special meeting of the Board on February 12, 2008, a resolution was passed, subject to approval of the Foundation, to approve final negotiations and authorize AVS' participation in the Agreement and Plan of Reorganization (Agreement) of Allegheny Valley School that had been negotiated by and among AVS, NHS and the Foundation.

- The finalized Agreement was dated February 13, 2008. It called for the Reorganization of AVS which required it to amend its Bylaws and Articles of Incorporation to replace the Foundation with NHS/AVS as the sole member and to obtain resignation of AVS officers and directors on the closing date of the Agreement. It was anticipated that at the closing the Foundation would have filed an application for tax exempt status as a Section 509(a) (3) supporting organization supporting AVS and it was acknowledged that, at any time following the closing, the Foundation could, at its sole discretion, elect to cease to be a supporting organization supporting AVS and elect to be treated as a private foundation or other designation completely independent of AVS and/or NHS.

In consideration of the reorganization and terms and conditions, the parties agreed to the following:

1. NHS agreed to pay the Foundation $27 million for the sole membership interest in AVS.

2. NHS agreed to accept the newly created liability by AVS of a certain deferred compensation plan in the approximate amount of $3 million (AVS President/CEO deferred compensation plan).

3. AVS agreed to transfer to the Foundation, at or before closing, all right, title and interest in and to the intellectual property known as the "Terrible Towel" along with all right to future related royalties. Provided that the name, mission and purposes of AVS continue in substantially similar manner as before the reorganization, as reasonably determined by the Foundation, AVS will remain the sole beneficiary of the "Terrible Towel" royalties and shall submit proposals for the use of the royalties for approval by the Foundation. AVS will continue to own and operate the AVS Gala, AVS Annual Golf Outing and its participation in the Pittsburgh Grand Prix.

4. AVS agreed to transfer to the Foundation, on or before the closing, all right, title and interest in and to an endowment (then current balance approximately $1.6 million) and specified bequests as received, to the extent permitted by law.

5. NHS agreed to offer employees in good standing of the AVS senior management team comparable positions with comparable compensation and benefits with AVS, NHS or an affiliate for a minimum of two years after the closing, subject to the execution of an employment agreement.

6. NHS agreed to retain two members of the pre-merger AVS board of directors, selected by the Foundation and with approval of NHS, for a minimum of two years after the closing.

- In conjunction with the merger closing date of May 30, 2008, NHS-AVS, LLC issued $54 million of revenue bonds through the Pennsylvania Economic Development Financing Authority (PEDFA). The bond issue was used to finance NHS' $27 million payment to the Foundation in exchange for the sole membership interest in AVS and the remaining $27 million was used to refinance AVS debt.

Concurrent with considering a possible sale or merger of AVS, the Board also discussed a new employment agreement for AVS' President/CEO to replace his January 7, 2007 agreement. Several members expressed concern that because AVS maintains only minimal retirement benefits for its employees, despite 35 years of outstanding service, the value of the President/CEO's employer provided retirement benefits was not commensurate with his role, period of service and salary level.

A plan was developed which would provide the President/CEO with an annual retirement benefit equal to 2% of his final 3-year average salary for each year of service and was designed to provide a retirement benefit comparable to what CEO's of similar health care organizations accrue over their careers. The Board engaged the [redacted] a compensation consulting firm, to perform an analysis of compensation packages of CEOs at similar nonprofit health care organizations. Their analysis found that including the current cost as part of his compensation would place his total cash compensation near the 50th percentile of CEO/Presidents of similar organizations.

Based on this information, the Board adopted a resolution to establish a deferred compensation plan as outlined in the [redacted] letter and detailed in the President/CEO's new employment agreement. In the revised agreement, dated May 29, 2007, the deferred compensation plan benefit was specified to be $3 million.

The employment agreement required AVS to establish a Trust and make an initial contribution of $300,000 within five days of the agreement. This initial contribution was funded from AVS' general fund.

An additional $300,000 was to be contributed to the Trust on each anniversary date of the agreement to fund the plan. However, a change in control provision in the employment agreement, which was triggered by the NHS merger agreement, required that the difference between $3 million and the Trust balance on the effective date of the change of control (merger) be contributed to the Trust account within five days following the change in control and the total account balance be paid to the President/CEO in a single lump sum payment (reduced by applicable taxes) within 30 days.

The liability for the AVS' President/CEO "Good Reason Severance Payment"; which included the $3 million deferred compensation plan, $342,049 accrued leave payout and a $306,000 severance payout was relieved approximately 10 days after the May 30, 2008 merger closing. The primary source of funds for the payout was AVS' Funded Depreciation account.

As provided for in the merger agreement, several members of the pre-merger AVS senior management team were offered and accepted employment with post-merger AVS. This included the President/CEO who executed an employment agreement to continue in the same position for the period May 30, 2008 through December 31, 2013.

Objectives, Scope and Methodology

Our audit objectives were:

- To determine how AVS calculated and funded the Executive Director's (President/CEO) deferred compensation and accrued leave payout and to determine if they complied with all applicable policies, regulations and laws.

- To determine the effect of the AVS/NHS business combination on FY 08/09 and FY 09/10 AVS rates.

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.

Our review was conducted between December 2, 2009 and February 18, 2010.

In pursuing our objectives, we reviewed available fiscal/accounting records, audits, contracts, employment agreements, deferred compensation agreement, policies and other relevant documents. We also interviewed AVS staff and former members of the AVS Board of Directors. Our work was conducted in accordance with generally accepted government auditing standards. This report, when presented in its final form, is available for public inspection.

Results of Fieldwork

A. President/CEO Deferred Compensation and Accrued Leave Payout

Based on our audit, we determined that AVS calculated the President/CEO's deferred compensation and accrued leave payout of $3,648,049 in accordance with the "Good Reason Severance Payment" provision (5.3) of his employment contract dated May 29, 2007. According to this provision he was entitled to payment of:

- Accrued Obligations-Accrued vacation, personal holidays and perfect attendance days ($23,474).

- Accrued sick days ($318,575).

- The Account balance in the Deferred Compensation Plan ($3,000,000).

- Severance equal to the employee's annual salary in effect as of the date of termination ($306,000).

- Continued participation, at employer's expense in employer provided benefits.

According to AVS representatives, the primary source used to fund the President/CEO's Good Reason Severance Payment payout was AVS's funded depreciation account. Our review of AVS' FY 07/08 MR-46 Cost Report confirmed that a transfer of $3,402,670 was made on May 29, 2008, to close their funded depreciation account.

While the general concept of establishing a funded depreciation account is to segregate accumulated funds for future acquisition of depreciable assets used in rendering patient care or for other capital purposes related to patient care, the accumulated funds are assets of the provider and may be used for any Board approved purpose.

However, there are regulatory requirements on the treatment of the investment income earned on these funds if withdrawals from the funded depreciation account are used for purposes other than acquisition of depreciable assets used in rendering patient care or for other capital purposes. The effect of these requirements is addressed in Issue No. 1 of this report.

While the President/CEO's employment agreement did specify that part of his Good Reason Severance Payment included payment of accrued obligations, such as unused vacation, personal and perfect attendance days, this is in contrast to AVS' employee leave policy. AVS policy requires that vacation, personal and perfect attendance leave be taken within one year after earned or be forfeited. While the policy does provide for time limits to be extended by mutual consent of the employee, President/CEO and Human Resources Department, the general practice is "use it or lose it". The President/CEO's employment agreement also specified that he be entitled to payment for accrued sick days. However, the sick leave policy states that unused sick days are not reimbursable.

In order to comply with Internal Revenue Service (IRS) regulations regarding payments to persons able to exercise substantial influence over a tax exempt organization, the AVS Board of Directors took the following steps to establish a rebuttable presumption (as explained in IRS guidelines) that the deferred compensation and accrued leave payout were reasonable:

- Compensation was based on [redacted] survey and analysis.
- Discussion and approval of employment agreement and deferred compensation plan was documented in board minutes.
- Disclosure of the basis for its determination was also documented in board minutes.

B. Effect of Merger on FY 08/09 and FY 09/10 AVS Rates

As a result of the merger NHS took over management responsibility for a number of AVS functions formerly performed by AVS staff. This resulted in a FY 08/09 cost savings of $680,528 through the elimination of several AVS positions. However, this savings was more than offset by a $2,463,385 FY 08/09 management fee allocation by NHS to AVS. This represented a partial integration of NHS management functions into AVS. The net increase of $1,782,857 ($2,463,385 - $680,528) was part of a request for a funding increase made by AVS to the Office Development Programs (ODP) for FY 08/09.

For FY 09/10 AVS submitted a request to ODP for an additional $2,450,116 in management fee expense. This increase reflected a full integration of all NHS management services into AVS, and the addition of four new administrative cost centers plus a net increase in costs in existing NHS cost centers.

Cumulatively, from pre-NHS merger (FY 07/08) to fully integrated and expanded management services in FY 09/10, AVS costs have increased by $4,232,973 ($4,913,501 - $680,528).

This increase was partially offset by interest expense savings of approximately $500,000 annually realized as a result of refinancing of long-term debt.

Issue No. 1 - Investment Income Earned On Funded Depreciation Used To Fund the President/CEO Severance Payment Must Be Applied To Reduce Allowable Interest Expense.

As previously addressed, the primary source used to fund AVS' President/CEO Good Reason Severance Payment payout was AVS's funded depreciation account. Our analysis of the AVS' FY 07/08 MR-46 Cost Report confirmed that a transfer of $3,402,670 was made on May 29, 2008, to close their funded depreciation account.

According to the Medicare Provider Reimbursement Manual (HIM-15), subsection 226.4 B., "When funded depreciation is used by the provider for other than (1) the acquisition of depreciable assets used to render patient care; (2) investments; (3) loans to the general fund for current operating costs related to patient care; or (4) other capital purposes as described in subsection 226, the investment income earned on these funds while on deposit in the funded account shall be used to reduce allowable interest expense incurred during all cost reporting periods subject to reopening."

Our analysis of the account, and application of withdrawals on a last-in, first-out basis as required by subsection 226.4 B., indicates that $905,806 of the transferred amount represented investment income earned on the funds used for the severance payment.

Recommendations:

The BFO recommends that ODP ensure that the $905,806 of AVS' Funded Depreciation account investment income is applied to offset allowable interest expense incurred in all AVS cost reporting periods that are subject to reopening.

Issue No. 2 - Erroneous Allocation of the 2008 Bond Issue Interest Expense, Amortization of Issuance Costs and Related Fees Resulted in Excess AVS Expense of $69,656 for the 13 Month Period Ended 6/30/09.

As mentioned in the background section of this report, one-half of the $54 million 2008 bond issue was to be used to finance the NHS-AVS purchase of the sole member interest in AVS from AVS Foundation, and the remaining $27 million was earmarked for the refinancing of AVS debt. As such, 50% of the bond interest, amortization of issuance costs and bond related fees should be allocated to each NHS-AVS, LLC and AVS.

Our review of AVS financial records indicated that the portion of the bond related expense that was allocated to AVS by NHS was 52.58%.

Documentation provided by NHS as support for the 52.58% AVS allocation indicated the allocation was based on the total cost to refinance AVS debt which was $28,395,329, or 52.58% of $54 million. However, since only 50% of the bond debt or $27 million was applied to the refinancing and recorded as AVS long-term debt, only 50% of the bond related expense should be applicable to AVS.

The following schedule summarizes the difference between the total bond related expenses (bond interest, amortization of issuance costs and bond related fees) allocated at 50% versus the 52.58% recorded as expense on AVS books:

	Bond Expense @ 50%	Bond Expense per AVS Books	Difference
June 2008	$ 109,433	$ 116,024	$ 6,591
FY 08/09	1,284,745	1,347,810	63,065
Total (13 mos.)	$1,394,178	$1,463,834	$69,656

Recommendations:

The BFO recommends that ODP ensure AVS' allowable 2008 bond issue related interest expense, amortization of issuance costs and bond related fees expense is reduced by $6,591 and $63,065 in the audit settlements for FY 07/08 and FY 08/09, respectively.

The BFO also recommends that AVS ensure that subsequent fiscal year cost reports reflect the appropriate allocation of the 2008 bond issue related expenses.

A closing conference was held with AVS and NHS management on February 18, 2010, to discuss the contents of this report. Their response to this report is included as Appendix A.

In accordance with our established procedures, an audit response matrix will be provided to your office. Once received, please complete the matrix within 60 days and email the Excel file to the DPW Audit Resolution Section at:

RA-pwauditresolution@state.pa.us

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

Please contact Alex Matolyak, Audit Resolution section, at (717) 783-7786 if you have any further questions concerning this audit or if we can be of any further assistance in this matter

Sincerely,

Kevin M Friel

Kevin Friel

ALLEGHENY VALLEY SCHOOL'S RESPONSE TO THE DRAFT REPORT

APPENDIX A

NHS
HUMAN SERVICES
NHS CORPORATE HEADQUARTERS
620 E. GERMANTOWN PIKE
LAFAYETTE HILL, PA 19444
610.260.4600
WWW.NHSONLINE.ORG

May 3, 2010

Mr. Michael J. Kiely
Department of Public Welfare
Bureau of Financial Operations
Western Field Office
Room 320
11 Stanwix Street
Pittsburgh, PA 15222

RE: Allegheny Valley School Audit Report Response

Dear Michael:

Attached please find Allegheny Valley School's written response to the draft audit report issued March 24, 2010 by the Bureau of Financial Operations. We have included the response labeled Appendix A to be included in the Bureau's final report.

If you should have any questions concerning this response, please feel free to contact me directly at 610.260.4615.

Sincerely,

Kevin W. McClure, CPA, MBA
Chief Financial Officer

Allegheny Valley School (AVS)
Response to Bureau of Financial Operations (BFO) draft audit report, dated March 24, 2010
Appendix A

Issue No. 1 – Investment Income Earned on Funded Depreciation Used to Fund the President/CEO Severance Payment Must be Applied to Allowable Interest Expense.

By way of background, AVS amended its employment agreement with its Executive Director, Regis Champ, on May 29, 2007 to include a Deferred Compensation Plan ("Plan"). The agreement included a provision that, upon a change in control of at least fifty (50%) percent of AVS, the total value of the Plan was required to be funded by AVS and that Mr. Champ would have the right to complete distribution upon his termination/resignation.

Northwestern Human Services, Inc., ("NHS") acquired AVS on May 30, 2008. Mr. Champ resigned employment from AVS on or about May 30, 2008. On or about May 29, 2008, AVS entered into an Escrow Agreement that provided that it would fully fund the Plan to be available for payment to Regis Champ upon termination of his employment agreement.

Subsequent to the acquisition, Mr. Champ was rehired by AVS pursuant to a five year employment agreement without any deferred compensation program. He was reemployed at the insistence of NHS to provide a continuity of management and executive skills in the specialized area of IDD services.

Mr. Champ has been employed by AVS for 38 years. He built AVS from a small facility employing sixty (60) people to one of the largest providers in Pennsylvania serving more than 900 special needs individuals, employing more than 2,500 people and with annual revenues of more than $120M.

During Mr. Champ's 38 years of employment, AVS never addressed the issue of his retirement in affording him a plan consistent with his body of work and accomplishments, the ability of AVS to provide such a plan, and the nature of the non-profit behavioral healthcare industry in which he was employed. In May, 2007, the former AVS Board belatedly addressed this issue by adopting the Plan that was recommended by the [redacted] an international executive compensation consulting group. The [redacted] developed the Plan to be reasonable and consistent with Mr. Champ's: (i) length of service; (ii) performance; (iii) responsibility; (iv) nature of the organization and persons served; (v) position; and (vi) industry standards. Mr. Champ was included in the fiftieth (50^{th}) percentile of similarly situated CEO's in the industry with respect to compensation after the adoption of the Plan.

The NHS acquisition of AVS triggered the change of control provision of Mr. Champ's Employment Agreement, requiring AVS to fund the entire Plan for it to be available to Mr. Champ upon his retirement from AVS. The AVS Board authorized the Plan to be funded from the Funded Depreciation Account ("Account"), which included $905,806.00 in investment income earned on the Account.

REGULATORY BACKGROUND

The regulations governing payment to the ICF/MR Programs are set forth at 55 Pa. Code § 6211.1 et seq. Among the regulatory provisions is one that specifies that the Medicare Provider Reimbursement Manual ("HIM-15") applies in determining allowability of costs where the Chapter 6200 regulations are silent. HIM-15, at Section 226, Funded Depreciation, authorizes (but does not require) the practice of placing funds in a segregated account(s) for the acquisition of depreciable assets to be used in rendering patient care or for other capital purposes related to patient care. Investment income attributable to a funded depreciation account that becomes part of the account is not used to reduce/offset a provider's otherwise allowable interest expenses. (HIM-15, Section 226.2). Similarly, where funded depreciation is used for purposes other than acquisition of depreciable assets used to render care to clients, investments, loans to the general fund for current operating costs related to client care, or for other capital purposes, the investment income earned on the funded depreciation account is used to reduce allowable interest expense. (HIM-15 at Section 226.4B).

DISCUSSION

Having now reviewed the actions by AVS in using funds from its Account to support Mr. Champ's Plan, NHS acknowledges that the interest income within the Account that was utilized to support the Plan must be returned to the Account or that amount of interest income can offset allowable interest expenses incurred by AVS. As a non-profit organization dedicated and responsible for the day-to-day care, habitation and/or treatment of over 50,000 children and adults living with intellectual and behavioral health disabilities, NHS cannot absorb a reduction in otherwise allowable costs as a result of this inadvertent error in the funding of the Plan for Mr. Champ that occurred prior to the acquisition of AVS by NHS. Accordingly, NHS will replenish the Account in an amount equal to the investment income that was originally withdrawn from the Account, supplemented by the amount of additional investment income that would have been earned by the Account had the investment income not been removed from the Account. This action will fully restore the Account's investment income to its same position had the investment income not been utilized to fund the Plan. AVS will continue to maintain a detailed accounting of all capital expenditures from the Account. This process will be managed by the Director of Finance.

Issue No 2- Erroneous Allocation of the 2008 Bond Issue Interest Expense, Amortization of Issuance Costs and Related Fees Resulted in Excess Expense of $69,657 for the 13 Month Period Ended 6/30/09.

The 2008 Bond issue in total was $54,000,000 of which $28,395,329 related to the payoff of the AVS prior debt. AVS used these amounts to calculate a percentage to split various costs between AVS and the parent corporation. This percentage of 52.58% was used to allocate bond interest, amortization of issuance costs and other related fees to AVS. This was a reasonable and accurate allocation methodology, which was reviewed by AVS' external auditors during the audit for the fiscal year ended June 30, 2008.

However, AVS takes no exception with the methodology behind the calculation performed by BFO. This methodology for allocation of interest matches the placement of $27 million of debt on each of the books of NHS-AVS LLC, the parent organization, as well as AVS.

The methodology for the allocation has been adjusted in the current fiscal year to be in agreement with the methodology recommended by the BFO and the allocation will be made at 50% in subsequent periods. This process will also be managed by the Director of Finance.

Effect of Merger on FY08/09 and FY 09/10 AVS Rates

While not an issue requiring a response, the impact on the merger to the AVS rates was raised in the Executive Summary section and Section "B" of the Results of Fieldwork in the audit report. Therefore, we believe that a management response was appropriate for inclusion in the report.

The cost allocation plan of NHS Human Services, Inc. (NHS) is audited annually as part of the OMB Circular A-133 audits performed by the independent external auditors for each of the nine subsidiaries requiring such an opinion, including AVS. This plan is in place to accurately and fairly allocate the corporate administrative costs of the parent organization to each subsidiary that receives a benefit from the respective corporate departments. The administrative functions performed at the parent level include: Compliance, Executive Management, Chief Operating Officer, Accounts Payable and Purchasing, Payroll, Accounting, Business Operations, Internal Audit, Information Technology, Human Resources, Insurance, Communications, Facilities Management and general Administrative Services. The costs of these departments are allocated to each subsidiary receiving the benefits based on an applicable measurement (i.e. number of checks written, number of employees, square footage of facilities under management, direct costs).

For FY 08/09, the integration of AVS into NHS was an ongoing process, so AVS was allocated costs only from the Compliance, Executive Management, Chief Operating Officer, Accounts Payable and Purchasing, Accounting, Business Operations, Internal Audit, Information Technology, Communications and Facilities Management departments. Some of these departments were not fully charged as integration of services occurred throughout the fiscal year. For FY 09/10, the integration was nearly complete, and administrative costs for all departments except for payroll (which AVS maintains delivery of this service), are being charged to AVS.

In addition, total administrative costs continue to increase for NHS in order to maintain its position as an industry leader in quality and innovation. The NHS administrative and support systems are state of the art and have been nationally recognized as models for service. NHS has invested heavily to develop and maintain an infrastructure and information system to meet the needs of its clinical operations which are constantly growing. NHS is committed to the development of a state of the art electronic health record, as well as an updated billing system in order to keep up with the various electronic billing requirements of its many payers. The NHS Corporate Integrity Department program has been nationally recognized in the healthcare industry for the past two years. The NHS Facilities Management Department currently oversees over 650 properties, a number that grows along with the NHS organization. Other support areas such as Human Resources, Accounts Payable and Purchasing and Communications also have extended and expanded their services and resources to meet the growing and changing needs of NHS system wide. The implementation of service line management functions, including IDD services, during FY 09/10 is being done to insure that best practices, consistent quality programming and a robust Performance Improvement plan is consistent across all NHS subsidiaries.

The NHS reputation is such that most Pennsylvania counties now refer their most complicated cases and their most vulnerable consumers to NHS for care. Today, NHS provides care and services to 5000 individuals with intellectual and developmental disabilities, making NHS the largest provider in the state. NHS has developed a clinical cadre of professionals who are able to support individuals with the most challenging behaviors including dual diagnoses and other co-occurring disorders.

NHS has been successful in managing costs, even with these increased administrative and support services being provided to its subsidiary operating companies. Accordingly, when combined with regional and local administrative costs, its subsidiary programs continue to operate with levels of administrative costs that are within its contractual limits. In addition, it can be fairly stated that the acquisition of AVS by NHS has saved the critical mission that AVS provides daily for some of the most vulnerable lives in the Commonwealth. Prior to the acquisition, AVS had reached its borrowing limit on its line of credit with its bank, due partly to the normal lag between service provision and payment for services, but primarily to the extraordinary amounts of money that were tied up in the ICF/MR waiver and appeal acquisition by NHS and the parent organization's capability to reach the capital markets and to provide working capital, the mission of AVS would have been jeopardized.