COMMONWEALTH OF PENNSYLVANIA
DEPARTMENT OF PUBLIC WELFARE
BUREAU OF FINANCIAL OPERATIONS
3rd Floor Bertolino Building
Harrisburg, Pennsylvania 17105-2675

APR 24 2007

JOHN H. BUNGO, CGFM, CFS
DIRECTOR

TELEPHONE NUMBER
(717) 787-9200
FAX NUMBER
(717) 705-6334

Mr. Paul Stengle
Executive Director
ARC of Montgomery County
[redacted] Ridge Pike
Eagleville, Pennsylvania 19403

Dear Mr. Stengle:

I am enclosing the final report of ARC of Montgomery County (MARC), recently completed by this office. Your response has been incorporated into the final report and labeled as Appendix.

The final report will be forwarded to the Department's Office of Child Development and Early Learning (OCDEL) to begin the Department's resolution process concerning the report contents. The staff from the OCDEL 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 Richard Polek, Audit Resolution Section at (717) 787-8890.

Sincerely,

John H. Bungo

John H. Bungo, CGFM, CFS

Enclosures

cc: Ms. Harriet L. Dichter
Mr. Michael Stauffer
Mr. Todd Klunk
Ms. Maureen Cronin
Mr. Joseph Roynan
Mr. Eric Goldstein
Mr. Jeffrey Bechtel

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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JOHN H. BUNGO, CGFM, CFS
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TELEPHONE NUMBER
(717) 787-9200
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Ms. Harriet L. Dichter
Deputy Secretary
Office of Child Development and Early Learning
Room 521 Health and Welfare Building
P.O. Box 2675
Harrisburg, Pennsylvania 17105

Dear Ms. Dichter:

In response to a special request from the Montgomery County Office of Human Services, the Bureau of Financial Operations (BFO) performed an audit of the ARC of Montgomery County (MARC). This audit was conducted in response to a complaint filed by a MARC employee. The audit was performed to address the issues included with the complaint and to determine if there was any additional funds due back to Montgomery County.

The mission of the BFO, accomplished through audit and review activities, is to assist the Department of Public Welfare (DPW) management to administer human services programs of the highest quality, at the lowest cost, with integrity.

Results In Brief

- Included in the fiscal year 2005/2006 cost settlement process were costs, such as architect fees, legal fees, and a building appraisal, related to the purchase of the new building. These costs should have been capitalized and excluded from the settlement process.

- The new building purchased by MARC is more than twice the size of their existing building. A correct square footage allocation will be an important factor in ensuring the equitable distribution of cost to the Early Intervention (EI) Program.

Results In Brief (Continued)

- Beginning in fiscal year 2006/2007, counties that administer EI Programs have the option to wave the 4300.87 (b) and 4300.87(c) (2) occupancy regulations. If a waiver is approved, MARC will be able to charge fair market value in lieu of actual building costs within its rates. An independent building appraisal should be conducted by Montgomery County to ensure building costs allocated to the EI Program are equitable.

- The audit identified questioned costs of $84,871 which included building costs, government affairs activities, and various costs unrelated to EI services.

- The audit identified retained revenue in excess of the 3% limitation of $264,089 for fiscal periods ended June 30, 2004, June 30, 2005, and June 30, 2006.

Background

MARC is a not-for-profit children's services provider founded in 1950. MARC's current structure encompasses four separate but related entities. MARC primarily provides EI and support services to children with developmental disabilities ranging in age from birth to three. Additionally, MARC has an Advocacy Division, providing services to both children and adults, and the MARC Foundation which works to obtain private and public funding for the Advocacy and Children's Services Division. Finally, MARC's administrative division provides support for the other three entities. MARC furnishes therapy services in Montgomery, Chester, and Berks Counties with more than 80% of the therapy provided within Montgomery County.

Expenses related to a division are coded and charged directly to that division. Indirect costs and administrative costs are captured within the administrative entity and allocated to each division based on a ratio of cost to total cost. As a result, for fiscal year ended June 30, 2006, the Children's Services Division was allocated 94% of administrative costs.

Montgomery County requested this audit in response to a complaint letter sent by MARC's Director of Children's Services to MARC's Board of Directors and verbal complaints made by the Director of Advocacy. Both of these individuals were terminated during the summer of 2006. Additionally, while on-site, several other employees approached the audit team and expressed concerns about the management of the organization.

Background (Continued)

MARC employs 70 staff and approximately 100 independent contractors. Until February 2007, MARC rented its main office space in King of Prussia, PA and a satellite office in Hatfield, PA; after which MARC purchased a new building located in Eagleville, PA, where both offices will be consolidated.

Montgomery County officials have expressed concerns over the financial strain the new building may put on the agency's viability. MARC is one of the counties primary EI providers; however, even more significant is the county's concern about the viability of the ARC which MARC is the sole county provider.

MARC's EI Program is governed by Pennsylvania Code, Title 55, Chapter 4300 Regulations. MARC's management has questioned whether the application of the 4300 Regulations to the EI Program is appropriate. This disagreement is based on the point that DPW established maximum allowable rates for EI services. However, the published rates are maximum limits, and counties are required to negotiate rates and cost settle contracts. Therefore, application of the 4300 Regulations is appropriate. Both DPW and Montgomery County management have confirmed this position.

Objective/Scope/Methodology

The BFO's objective was to ensure MARC is operating at an expected level of economy and efficiency; in compliance with all program requirements and regulations, and that the EI rates are reasonable and equitable.

In pursuing this objective, the BFO reviewed financial statements, general ledger accounts, vendor invoices, payroll records, and selected job descriptions. The BFO also conducted interviews with key staff, MARC board members, and county officials.

Governmental auditing standards require that auditors obtain an understanding of management controls that are relevant to the audit objectives described above. The applicable controls were examined to the extent necessary to provide reasonable assurance of compliance with generally accepted accounting principals. Based on the BFO's understanding of the controls, no significant deficiencies came to our attention other than those described in the issues in this report.

The BFO fieldwork was conducted intermittently between December 6, 2006 and January 26, 2007, and was performed in accordance with generally accepted government auditing standards. This report, when presented in its final form, is available for public inspection.

Results Of Fieldwork

As indicated an employee filed an official letter of complaint to MARC's Board of Directors stating several areas of concern. In addition, other employees expressed concerns to the audit team in a less formal manner. These complaints, in part, formed the basis of our audit. In examining the complaints the following were determined to be unfounded:

- Builders Non-Compliance With The Prevailing Wage Statue - This issue was determined unfounded. MARC did not receive the PA Commonwealth Capital Budget grant which included a prevailing wage requirement. Furthermore, the HUD grant that was received did not require compliance with the prevailing wage statue.

- Mandatory Employee Contributions To Building Fund - While the MARC Foundation conducted a capital campaign and employees were strongly urged to contribute, no mandatory participation was required.

- Inappropriate Use Of EI Funds For Building Down Payment - MARC did use funds generated by the allowable 3% retained revenue clause in their Montgomery County contract as a building down payment. Montgomery County does not impose any restrictions on these funds; therefore, MARC's use of the funds in this manner is warranted.

- Certain Legal Costs - MARC was in process of exploring a vehicle donation program and certain legal costs associated with this program caused concern. Upon review of the legal costs, this issue was determined as unfounded. MARC terminated its involvement in this program shortly after it started.

The remaining concerns and/or complaints are addressed in issues that follow:

Issue No. 1 – Impact Of Building Purchase

On February 17, 2006, MARC entered into an agreement with [redacted] to purchase a building at [redacted] Ridge Pike, Lower Providence Township, Montgomery County, Pennsylvania. MARC's intended use of this building is to supplant their rental space with property ownership so as to benefit from the privileges of ownership. The cost of the building is $3.9M plus building upgrades of approximately $200,000 and closing costs. It is estimated that the final cost of the building is approximately $4.2M. The agency had settlement and took possession on February 1, 2007.

Results Of Fieldwork (Continued)

In order to finance the building purchase, MARC applied for various federal, state and private grants, engaged in a capital campaign, and solicited funding by making the general public aware of its building project. Also, during the period of time between entering into an agreement of sale and building settlement, MARC incurred various costs associated with this capital project. Warranted or unwarranted, these business practices raised concerns with employees of MARC. The concerns were brought forth to MARC's primary funding source, the Montgomery County Department of Human Services, who in turn requested the DPW through the BFO to address various concerns pertaining to the building and related transactions.

Prior to entering into the building sales agreement, MARC did not request a funding commitment or a position of accord from Montgomery County management.[1] However, MARC management solicited Montgomery County to be allowed to keep funds in excess of the 3% retained revenue allowance to be used towards the building purchase. This request has not been addressed; as such, the county is anticipating recovery of funding in excess of the 3% allowance.

Funding For The New Building

In attempting to acquire funding for the building purchase, MARC applied for several grants, the largest being a grant through the Commonwealth of Pennsylvania Capital Budget for $1.5M. While MARC management indicated the Capital Budget was approved, MARC was not chosen to receive a grant. MARC did receive a $248,000 HUD grant which was applied towards the building down payment, a $35,000 Phoenixville Foundation grant, and several small private grants, the most significant being an $85,000 bequest.

Because MARC did not receive a significant portion of the funding they were anticipating, they opted to secure a mortgage for 80% of the cost of the building from a local bank. Due to the brief period between the loan application and settlement, MARC could only obtain a short term loan at 6.5% which will have to be refinanced within 60 days of the settlement date (February 1, 2007).

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[1] Requesting funding or concurrence for a capital purchase is not a regulatory requirement. However, it may be good business practice for non-profits such as MARC to obtain concurrence with their major funds prior to making certain capital purchases.

Results Of Fieldwork (Continued)

Costs Associated With The Building Purchase

During Fiscal Year 2005/2006 MARC incurred development and start up costs associated with the new building purchase (see Issue No. 2). These costs were charged to the Administration Division and then allocated to the Children Services Division. Eventually MARC included these costs in the county cost settlement process for fiscal year ended June 30, 2006. Similar costs are also being incurred in fiscal year 2006/2007. Costs of this nature, building development expenses, should be capitalized and expensed over the useful life of the asset.

MARC did receive a $35,000 grant that could be used towards construction costs. Marc recorded the grant revenue within its Foundation Division and did not use these funds to offset construction costs that were recorded in the Administration Division. MARC management stated that they choose to use the grant funds at settlement instead of applying them to costs that were incurred prior to settlement.

Square Footage

Pertaining to space at MARC'S King of Prussia rental property, program staff was using approximately 4,700 of the 10,000 square feet of office space; 1,100 square feet were subleased to the Montgomery County Intermediate Unit; the remaining space consisted of common areas and storage space. Additionally, staff space was rented in Hatfield. It is planned that staff at this site will be consolidated with the King of Prussia staff in the new building.

The new building purchased by MARC is 22,000 square feet. As such, the new building is more than twice the size of their rental space. Management stated that they needed more space to host staff meetings, trainings, and anticipated expansion into Berks and Chester counties.

Montgomery County has expressed concerns regarding the size of the building as the EI Program is designed to deliver home based service not center based service. For future therapy rates, MARC will have to clearly identify the space used by the EI Program so that all counties purchasing therapy are ensured that the occupancy costs component of the therapy rate only includes space that is associated with the efficient use of program resources. It will be MARC's challenge to ensure the building is fully occupied as only cost associated with the EI Program can be included in the EI rates. For example, the building blueprint indicates the establishment of two gyms. It will not be appropriate to include cost associated with non program related space within the EI therapy rates.

Results Of Fieldwork (Continued)

Rental Costs Charged To Montgomery County

Beginning in fiscal year 2006/2007, for EI funded services, counties may approve a wavier of specific occupancy regulations such as 4300.87(b) and 4300.87(c) (2) allowing fair market value on rental costs for less than arms length transactions to be used as a component factor of negotiated rates. As a rule, fair market value is usually established with an appraisal of the property in question. If the county grants a waiver of these regulations, it would be beneficial for the county to obtain their own appraisal of MARC'S building in order to ensure an equitable fair rental charge.

Recommendations

The BFO recommends MARC properly capitalize the building start up costs so as to include total costs associated with the building purchase in the cost basis of the building. Review of building cost is necessary for both fiscal years 2005/2006 and 2006/2007.

The BFO also recommends Montgomery County ensure efficient use of the building space by MARC. A proper space allocation between the EI Program and other building users should be periodically verified by county personnel. Only the space related costs associated with the EI Program may be included in the individual therapy rates. Additionally, MARC needs to ensure space not occupied by EI is sublet generating additional revenue to cover the building costs not covered by the EI Program.

Finally, the BFO recommends if MARC opts to apply for a waiver of the 4300 Occupancy Regulations, Montgomery County should obtain its own fair market appraisal to ensure the costs included in their contracted rates are fair and equitable.

Issue No. 2 - Questioned Costs ($84,871)

In reviewing expenses charged to the EI Program, either directly or indirectly, certain expense items were identified as unallowable. These expenses include items related to the purchase of the new building, government affairs activities, and expenses unrelated to EI services. Total questioned costs that were removed from the EI Program for cost settlement purposes were $84,871.

Expenses Related To New Building – ($37,658)

Expenses related to the purchase and construction of the new building were included in administrative costs and allocated to the EI Program at a ratio of 94%. These expenses included legal fees ($13,226); architect fees ($21,937); building appraisal ($4,000); and a sign ($900).

Results Of Fieldwork (Continued)

While these costs may be considered allowable under certain circumstances, for the fiscal year 2005/2006 Montgomery County El Program cost settlement process, these costs are unallowable. As indicated, building development costs are generally capitalized and expensed over the useful life of the building. Furthermore, rates agreed to between MARC and Montgomery County did not include reimbursement for both building rent and building development. A total of $40,063 was removed from administration resulting in a $37,658 decrease to El Program costs.

Government Affairs Activities – ($19,259)

MARC's personnel, as part of its activities related to the ARC, attend annual conferences to discuss issues and legislative initiatives related to persons with mental retardation and development disabilities. While attending these conferences, staff and board members met with various legislators to discuss legislation and funding. The DPW does not participate in these types of expenses. A total of $10,488 was removed from administration, resulting in a $9,859 decrease to El Program costs.

Additionally, MARC made a one time donation of $10,000 to the ARC of Pennsylvania over and above their normal membership dues. While membership dues to the local and national ARC are allowable, this added donation of $10,000 is not an allowable cost. As a result, administration expense was reduced by $10,000, resulting in a decrease to El Program costs of $9,400.

Costs Unrelated to El Services – ($27,954)

As part of its administrative function, MARC incurred expenses to promote public relations and staff morale. While this is a good business practice, generally these types of expenses are unallowable for public funding.

Therefore, the following costs were removed from the cost settlement process:

- Meals ($5,282) - MARC's Executive Director meets with various state and county officials over lunch and dinner. These meals are charged to administration. Cost identified for meals was $3,983, resulting in a decrease to El of $3,744. Additionally, there was $1,538 in meals charged directly to the El Program. As a result, the total decrease to the El Program was $5,282.

Results Of Fieldwork (Continued)

- Staff meetings, parties and gifts ($14,313) - MARC provided baseball tickets and food to its staff for a cost of $10,850. Additionally, the agency sent flowers to staff, state and county officials; purchased various holiday gifts and hosted a retirement party. The costs identified for these items was $4,246. While these items are perks that help promote staff morale and good will, the DPW does not participate in this type of expense. In order for MARC to continue these activities they must pursue funding other than with taxpayer dollars. As a result, $13,053 was removed from administration, resulting in $12,270 being removed from EI. Additionally, there was $2,043 removed from EI which had been directly charged.

- Toy Grant ($2,000) - MARC received a $2,000 grant to purchase toys for the EI Program. Expenses related to the purchase of the toys were included in the current fiscal year's cost settlement process. As a result, $2,000 related to the purchase of EI toys was removed from EI costs to reflect the grant revenue received.

- An extra month of credit card purchases was included in the fiscal period examined ($6,359) - MARC inadvertently included credit card purchases pertaining to 13 months of cost. There was no adjustment posted in the general ledger for these expenses. As a result, direct cost of $4,458 was removed from EI; and indirect cost of $2,022 was removed from administration, resulting in an additional $1,901 removed from EI.

Recommendations

The BFO recommends Montgomery County review these questioned costs and determine if they are appropriate to be included with other allowable costs when calculating the fiscal year 2005/2006 contract settlement. If determined unallowable, Montgomery County should require payment.

Additionally, the BFO recommends the county ensure these types of expenses are not included in future years contract/cost settlements.

The BFO also recommends MARC pursue alternate funding from private sources if management wishes to continue providing some of these benefits to their staff.

Results Of Fieldwork (Continued)

Issue No. 3 - MARC Had Excess Retained Revenues For Three Fiscal Periods Totaling $264,089

Based on a request from Montgomery County, we analyzed retained revenues for the three fiscal years ending: June 30, 2004, June 30, 2005 and June 30, 2006. As part of this analysis, we accounted for subsequent payments and expenses within each fiscal year. For the fiscal year ended June 30, 2005, MARC had repaid $94,486 to Montgomery County. Additionally, for the fiscal year ended June 30, 2006, questioned costs identified in Issue No. 2 were included in the calculations.

For the three fiscal periods analyzed, excess retained revenues were identified as follows:

FY 2003/2004	$ 16,836
FY 2004/2005	8,685
FY 2005/2006	238,568
Total Due To Montgomery County	$264,089

In accordance with MARC's contract with Montgomery County and the 4300 Regulations, revenues in excess of 3% of eligible expenditures must be returned to the county. Additionally, MARC is required to notify the county as soon as it determines there are funds in excess of the allowable 3% limit.

Recommendations

The BFO recommends Montgomery County recover the excess revenues identified above. The $264,089 is the total amount to be recovered as it includes questioned cost. Subsequent to the close of fieldwork, MARC made a payment to Montgomery County of $173,103. As a result, the remaining balance due to Montgomery County is $90,986.

Additionally, the BFO recommends MARC ensure the necessary procedures are in place to identify excess retained revenue and promptly notify the county of these excesses.

Results Of Fieldwork (Continued)

Observation - The Purchase Of The Building May Affect MARC's Ability To Provide EI Services

During the audit process both Montgomery County and DPW management have expressed concerns over MARC's ability to continue as a viable EI provider due to the cost and financial strain the building purchase has put on the agency.[2] Factors contributing to this condition are both within and outside the control of MARC's management.

Because MARC was unable to obtain the grants they had anticipated using for the purchase of the new building, the purchase required MARC to use established equity (cash) for the down payment and related building expenses incurred prior to settlement. As such, MARC needed a larger mortgage, resulting in the agency incurring more principle and interest costs than originally expected.

As indicated, the building purchased is more than twice the size of the space that MARC was renting. While MARC anticipates consolidating program staff from two sites, it does not appear that MARC will need significantly more space on a daily basis to administer its publicly supported programs. As MARC's programs are currently structured, much of the cost of the new building can not be reimbursed through public funds, resulting in additional financial strain on the agency. MARC's management will need to follow through on its stated intentions to lease a significant portion of building space.

Another factor affecting the agency's cash flow relates to their contract with Montgomery County. MARC's contract for the fiscal year ended June 30, 2007, for EI services is $2,974,788; as of December 31, 2006, they had already incurred $2.9M in expenses. The primary reason expenditures will be in excess of the contract ceiling relates to the delivery of services. Referrals and authorization have exceeded the anticipated amount. Traditionally, Montgomery County will amend the contract to allow payment for these services; however, as of the close of fieldwork, no such amendment was in place. In the past, funds provided under the amendments have been somewhat delayed. Again, due to factors beyond the individual funding unit's control, funding can be slow to come forth. Providers who administer programs of this nature must be aware of funding constraints and ensure adequate equity is available for potential funding delays.

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[2] Government Auditing Standards encourage on going communication with all parties throughout the audit process.

Results Of Fieldwork (Continued)

Further compounding MARC's financial status is end of year payments and/or supplemental payments which also tend to come slowly from the county. This is due in part to MARC not forwarding the required reporting documents to the funding source; however, there are other factors that may cause the county to be slow in paying providers.

The added costs associated with the building, additional referrals, and slow payments from the county all add up to potential cash flow problems and the possibility that MARC may not be able to manage the cost of the building and still provide EI services effectively. In addition to leasing space, MARC's management may want to pursue some sort of diversification to augment cash flow. However, in the interim MARC must prudently manage their expenditures in order to maintain their current service quality level.

Exit Conference/Summation

At the request of MARC's management, an audit exit conference was held on April 11, 2007. In attendance, along with BFO and MARC staff, were representatives from the Office of Child Development and Early Learning (OCDEL) and Montgomery County Human Services. Based on discussion at the meeting, it was agreed that BFO would reconsider its exclusion of costs associated with meals for staff training. A monetary amount was added back to allowable costs and the retained revenue calculation was adjusted. Additionally, BFO agreed to clarify Issue No. 3 indicating MARC's repayment of a portion of the identified retained revenue due to the county. No other changes were made to the report; however, the BFO elects to clarify certain comments made by the auditee in their response to this audit:

- MARC stated that "all of the concerns of the BFO were either calculation or allocation errors." The BFO took no exception with the allocation methodology used by MARC. Both expenses and retained revenues were recommended for repayment to the county program based on the application of regulations 4300.28 (a) (c), 4300.108 (b), and the contract between Montgomery County and MARC.

- MARC expressed that they must be held to "...the same standards to which other early intervention providers are held.", and the "...BFO [must] deal with agencies in a standard manner." The BFO consistently applies the applicable program regulations to all agencies under audit.

Exit Conference/Summation (Continued)

- MARC reported that Montgomery County approved their preserving of retained revenue in excess of 3%. Documentation and discussions with county personnel indicated that Montgomery County did not approve MARC to retain revenue in excess of the 3% stated in their contract. Additionally, the county's methodology in calculating excess retained revenue is based on eligible expenditures and has remained constant.

In accordance with our established procedures, please provide a response within 60 days to the Audit Resolution Section concerning actions to be taken to ensure that the report recommendations are implemented.

Please contact Richard J. Polek, Audit Resolution Section, at (717) 787-8890 if you have any questions concerning this matter.

Sincerely,

John H. Bungo

John H. Bungo, CGFM, CFS

Attachments

cc: Mr. Michael Stauffer
Mr. Todd Klunk
Ms. Maureen Cronin
Mr. Joseph Roynan
Mr. Eric Goldstein
Mr. Paul Stengle
Mr. Jeffrey Bechtel

EXHIBITS

MARC
Comparision of Comtracted Rates to Audited Rates
Fiscal Year Ended June 30, 2006

Service Types	Total	Education	Speech	Occupational	Physical	Social Work	Nutrition
Units	**207,212**	90,894	40,246	41,048	26,436	5,656	2,932
Total Expense	**$ 5,055,386**	2,053,400	1,060,868	974,612	708,956	184,247	73,303
Audit Questioed Costs	**$ (84,871)**	(34,473)	(17,810)	(16,362)	(11,902)	(3,093)	(1,231)
Adjusted Expense		2,018,927	1,043,058	958,250	697,054	181,154	72,072
3% Retained Revenue		60,568	31,292	28,747	20,912	5,435	2,162
Total Adjusted Cost		2,079,495	1,074,350	986,997	717,965	186,588	74,235
Audited Rate		$ 22.88	$ 26.69	$ 24.04	$ 27.16	$ 32.99	$ 25.32
Contracted Rate Fiscal Year 05/06		$ 24.16	$ 28.83	$ 28.80	$ 29.43	$ 26.94	$ 24.16
Difference		$ **(1.28)**	$ **(2.14)**	$ **(4.76)**	$ **(2.27)**	$ **6.05**	$ **1.16**

EXHIBIT A

MARC
Retained Revenue Analysis

	FY 2003/04	FY 2004/05	FY 2005/06
Montgomery Coutny Revenue	$ 2,841,669	$ 3,475,959	$ 4,581,158
Adjustments to Revenue:	(73,475)	98,140	-
Adjusted Revenue	2,768,194	3,574,099	4,581,158
Montgomery County Expense	2,671,221	3,369,833	4,216,107
Excess Revenue Over Expense	96,973	204,266	365,051
3% Allowance	80,137	101,095	126,483
Excess Retained Revenue	$ 16,836	$ 103,171	$ 238,568
		a	b

a) MARC repaid $94,486, leaving a balacne due of $8,685, due to Montgomery County.

b) Subsequent to the close of field work, MARC repaid $173,103, leaving a balance of $65,465 due to Montgomery County for fiscal year 2005/06

EXHIBIT B

AUDITEE'S RESPONSE
APPENDIX

The Arc
Established 1951
of Montgomery County

[redacted] Ridge Pike
Eagleville, PA 19403
Phone: 610.265.4700
Fax: 610.265.3439 www.marcpa.org

April 13, 2007

Thomas P. Crofcheck
Audit Director
Bureau of Financial Operations
Division of Audit and Review
3rd Floor, Betolino Buildong
1401 North Seventh Street
PO Box 2675
Harrisburg, PA 17105-2675

Dear Mr. Crofcheck:

This letter is written in response to your "draft" proposed performance audit report regarding The Arc of Montgomery County (MARC), as prepared by the Division of Audit and Review (DAR). We ask that you reconsider certain assumptions and conclusions in the draft report based on the information supplied in this letter.

All of the concerns of the Bureau of Financial Operations BFO), were either calculation or allocation errors. The task of the calculations and allocations was that of the controller of The Arc of Montgomery County who is no longer with the organization. Once the county specifies how these calculations should be determined and how the allocations should be reported, we will readily comply.

Introduction

It is important to note that The Arc of Montgomery County and its subsidiaries are parent-run organizations. That is, 50% of our Board members are parents of, or persons with, disabilities. The Arc of Montgomery County is a member of The Arc of Pennsylvania and The Arc of the United States. A primary focus of our mission is to support, advocate for and train persons with disabilities and their families about issues that are critical to them. The provision of early intervention services and advocacy services support our vision and mission in this area.

In response to a special request from the Montgomery County Office of Human Services, DAR, a division of the Bureau of Financial Operations (BFO) in the Pennsylvania Department of Public Welfare (DPW), performed an audit of The Arc of Montgomery County (MARC). We understand the audit was conducted in response to a complaint filed by a former MARC employee who was terminated from employment prior to the audit. Initially, we were informed that the audit was to investigate the concerns expressed in a letter from the terminated staff person. That complaint was initiated long before we were notified of DAR's intention to conduct an audit. The audit evaluated issues beyond those concerns, many of which were determined to be unfounded. As a result, we have been dealing with the alleged complaints raised first to Montgomery County and now through the DAR audit for close to a year. We hope that this letter and our exit interview produce a speedy resolution to these matters.

Serving people with developmental disabilities since 1951...

We appreciate how quickly the auditors responded to our request to begin the audit as soon as possible. The audit began within a week of MARC's receipt of notification of the audit. In addition, we were impressed with the thoroughness of your audit. MARC was willing to cooperate fully with DAR's request. We have nothing to hide, and we were simply interested in seeing the audit through to its conclusion with as little disruption to our operations as possible.

Our one concern regarding the conduct of the audit is that the auditors initially seemed unwilling to come to me for information. It was only when I brought this issue to the auditors attention that I was approached on some matters. Instead, DAR relied significantly on the input of our controller and office manager, both of whom have been terminated from MARC for serious performance issues unrelated in any way to the audit. In other words, much of the information fueling this audit came from disgruntled employees.

Responses to Findings

Initially, we were pleased to see that DAR concluded that the following areas of complaint were unfounded:

- Builders Non-Compliance With The Prevailing Wage Statue - There was no non-compliance with the prevailing wage statue. As DAR notes, we were not required under any of the funding that we received to apply the prevailing wage statute. Remarkably, this complaint was made even though we set a condition on our builder to meet the prevailing wage statute because we were hopeful that we would receive funding from the Commonwealth Capital Budget grant which would have required prevailing wages.

- Mandatory Employee Contributions To Building Fund – As DAR concluded, there was no mandatory requirement for employees to contribute to the building fund. We would further stipulate that there was no reward in merit increases based upon whether or how much staff contributed to the capital campaign.

- Inappropriate Use Of EI Funds For Building Down Payment - There was no inappropriate use of EI funds for the building payment.

- Certain Legal Costs – We also concur that legal fees related to the vehicle donation program were not an issue. MARC was reimbursed by [redacted] for all costs incurred by the vehicle donation program, and we received $45,000 that was distributed evenly between the three Arcs participating in this program. All costs related to the vehicle donation program were reimbursed, and we received a net of approximately $15,000 for participating in this program.

Next, we reply to each of the issues identified in DAR's draft proposed audit report, as described in the Issues in Brief and DAR's longer description of each issue.

Issue No. 1 – Impact of Building Purchase

We are surprised that DAR focused so extensively on the new building under the current circumstances. This is one area where we would have hoped that DAR would have discussed the issues more thoroughly with management during the audit field work. The decision to acquire property, rather than rent, is supported by DPW's regulations, which state that DPW will participate in such costs "[t]o encourage the continued use of owned real estate in the county program." 55 Pa. Code § 4300.87(c).

DAR's questions regarding the building can be categorized into three areas: (1) size of the building, (2) cost of the building and (3) development expenses associated with acquisition of the building.

Size of the Building

The draft audit report states that MARC's acquisition of a building for its operations more than doubled its current space. It raises questions about need for the space, allocation of space for the EI program and ability to sublet space. DAR's questions about the size of the building are unfounded, particularly when put in perspective, considering MARC's experience with rental space, increased program size, staff growth and new regulatory responsibilities affecting space.

The current space for MARC and the EI program was totally inadequate because of past issues. MARC should not be expected to continue with those inadequacies, but should be applauded for correcting longstanding problems. The reason for the insufficient space stems from prior inequities in funding of early intervention services (i.e., MARC was not reimbursed for travel expenses, while other providers were, which meant that like providers in other counties got up to an additional 50% reimbursement in their rates). As a result, MARC needed to substantially decrease its costs. As part of that effort, we reduced our ranks of necessary support staff, including our Human Resource Director and a number of secretaries. Furthermore, we substantially reduced our space over the last 10 years. Ten years ago, we operated a facility in King of Prussia with approximately 10,000 square feet. We also had a site in Pottstown of about 2,800 square feet and a facility in Hatboro/Horsham with approximately 2,400 square feet. Thus, ten years ago, MARC utilized 15,200 square feet of rented office space with about 40 employees.

Prior to our move to the new building, we occupied about 10,000 square feet of office space, with about 80 employees. We closed our Pottstown center and had administrative and direct staff in the Pottstown area and Chester and Berks County staff working from their homes. Our site in Hatboro/Horsham is in terrible physical condition which had placed staff in an unsafe and unhealthy work environment. We needed to provide appropriate space for them. Furthermore, of our 80 staff, only 31 have permanent office space. As the size of our program grows, it is essential to have the administrative staff to support it and the space in which to house these staff. With a 50% increase in staff over the last 10 years, a 25% increase in office space (15, 200 square feet to 22,000 square feet) over the same time period is reasonable and appropriate.

There are other reasons why MARC needed to increase its space. New regulations and requirements of the State related to the provision of early intervention services mandate additional uses of space. Two prime examples of this are: (1) staff training requirements, and (2) data entry requirements. With respect to training, all staff must receive at least 24 hours every year. To save on costs, MARC supplies its own training and conducts monthly education for all staff. In the old facility, we tried to train 80 staff in a space that seated 20 individuals comfortably. The new facility will permit us to do large trainings of early intervention staff on a monthly basis. With respect to data processing, our staffing needs have increased dramatically because of implementation of the mandated EIR data system and the Promise data system. Over the last 10 years, we have increased our data entry staff from one to six. These data entry persons also have responsibility for over-seeing record keeping and documentation from staff and consultants concerning the provision of services, as well as seeing that such things as training requirements are met and documented.

MARC's staffing needs and consulting needs continue to increase exponentially. Our funding for the provision of early intervention services has increased approximately 15% per year over the last 20 years because we are serving more children. This increase in funding has created an increase for additional space because of the duties that go hand-in-hand with managing an escalating caseload. As indicated above, although our rental space has decreased over the last 10 years until purchase of this facility, our rental needs have increased. In addition, we had discussed our plans to purchase this facility in detail with county staff including the MR Administrator. We were very transparent about our efforts to purchase this building, and indicated that if all of the funding solicited for the building was received, we would have a reduction in our monthly rental/mortgage cost. Although we did not receive the capital grant, our need for the new space remained constant. It would not be responsible to continue operations where we were.

The report indicated that we do not provide center based services, which is true. But that has been the nature of the program since 1992. Still, our services, our budget, our staff and our regulatory responsibilities have grown and more space is necessary to accommodate this expansion. Further, certain statements were made in the report that implied poor use of space. For example, it was stated that MARC has two gyms. One gym is for young children birth to five, who need occupational and physical therapy. Adequate space is needed for the activities and equipment related to these services. The other gym is for staff to exercise in. This space would not be allocated to the EI program, but it is available to our staff to maintain health and relive stress. We did not think it was appropriate to mix these two purposes in the same space.

In addition we are actively looking to lease space that we will not be using. We are in negotiations with two non-profit organizations regarding the potential of renting space at our facility.

Cost of the Building

In our decision to purchase a new facility, we had several requirements placed upon us. Some of those are as follows:

1. We needed to contract with a builder who was willing to pay prevailing wages.
2. We needed to have the building located in specific legislative districts.
3. We needed to have a facility that was zoned appropriately.

4. We needed a facility that was easily accessible to bus routes and easily accessible to families.
5. We needed to have a facility that was fully accessible for people with disabilities.

In a two-year search for this facility, we were only able to find two locations that were initially able to meet the requirements above. Our preferential site was in Limerick, and we were unable to secure this facility because the builder decided that he was unwilling to pay prevailing wages. This meant that after two years of searching, we had only one location which met the requirements stated above. The builder needed to agree to build the facility at prevailing wages for less than the appraised value of the facility. We were able to meet this requirement with an appraised value of $4 million and a purchase price of $3.9 million.

One of the problems with the site when we committed to the purchase was that the foundation was in place. Thus, we were unable to control the square footage that we would purchase. We have also conducted square footage breakdowns where we have determined that 8% of the space is open space. We believe with the growth rate of 15% per year, it is reasonable to acquire additional space at the new facility. The total additional space cost is $1,277 per month.

Our rental costs for last year were $15,298.51 per month. If we are able to get an exempt mortgage rate, our new mortgage rate will be a fixed rate of 5.04% and will mean that we will be paying $18,781.53 per month. In both locations, we will be required to pay a triple net. We have not significantly increased our building expenses. The reason for this is that the new facility is extremely well insulated and heated with gas. The old facility was un-insulated and heated with electricity. Given the expanded space and the savings on utilities, an 18% increase in rental/mortgage costs is reasonable.

We have sent to the County Office of Mental Retardation blueprints of how space will be utilized and how we are allocating costs related to the new expense. We certainly are willing to follow the County's direction if they believe that any of the staff who has space at the new facility should not have office space.

We are confused about your indication that we can receive a fair market value in lieu of actual costs of building. We certainly have no preference of whether we bill the programs at actual costs or fair rental value; however, when this question was raised with you several times during the auditing process, you repeatedly indicated that you felt that we should sign lease agreements between the parent corporation and the related organizations based upon an actual cost basis.

<u>Development Expenses</u>

The development expenses that DAR suggests should be capitalized, i.e., legal fees, architect fees and appraisal fees, should not be capitalized because the following requirements for capitalizing these expenses under general accounting principles are not present:

1. *The cost is directly identified with the specific property.* Much of the costs in question did not relate specifically to the acquired property.

2. *The cost is capitalized if the potential property was already acquired.* The costs were incurred prior to the purchase of the property.
3. *Acquisition of the property is probable, including having the ability to finance.* MARC incurred these costs as it was evaluating whether to acquire and what our needs would be if we were to acquire property. These costs were necessary in making a sound decision.

Prior to June 30, 2006, none of these requirements were met, so your suggestion that certain expenses be capitalized is improper. The financing for this building was not secured from [redacted] Bank until after July 1, 2006. Part of the legal fees and architectural fees related to the purchase of a facility happened before an agreement was signed, and some of the architect fees and legal fees were related to our efforts to purchase another facility located in Limerick. Furthermore, a sales agreement was signed on April 12, 2006 in which we had until July 1, 2006 to meet due diligence to determine if we would proceed with the purchase of this facility. The cost related to our due diligence should not be applied as a capital expenditure because during that period we were not in an enforceable agreement to purchase the property. We were not able to meet all the terms of the initial agreement and needed to renegotiate a new agreement on July 5, 2006. The final agreement to move ahead with the purchase of the property with substantial penalties that the seller and/or MARC could incur if there was a breach in agreement was finalized after July 1, 2006. I would agree that any architect fees after July 1st should be capitalized. However, architect fees, legal fees, and building appraisals for other sites that were prior to the signing of the sales agreement and/or incurred during our due diligence period are not appropriate capitalized expenses, and thus should be expenses that are allocated proportionately to the programs under the corporate umbrella of MARC.

In conclusion, we determined that purchasing a new facility was appropriate for the following reasons:

1. An exponential cost in square footage space in Montgomery County deemed it appropriate that we would purchase the facility at a fixed mortgage rate to decrease the cost to MARC and its subsidiaries for rent/mortgages.
2. With a growth in program of 15% per year and a 3% retained revenue, cash flow at MARC has not only continued to be a problem but has been an increasingly greater problem as our cash needs expand greater than our ability to increase our asset base. In addition, future planning of the State contemplated doing away with advances. We determined it necessary to increase our asset base. Through the purchase of this facility, we have immediately increased our asset base by $800,000. This will permit us to increase our line of credit over the long term to meet our cash flow needs that are resulting because of our growth of services and changes in funding strategies of the Commonwealth of Pennsylvania.
3. We have endured dozens of moves over the last 20 years. Moving has been extremely expensive and time consuming. We believe that through a purchase of a facility we will be able to avoid moving costs and related expenses in the future.
4. We believe that the purchase of an office in Montgomery County was a fiscally sound decision in part because of the escalating costs of commercial real estate in Montgomery County.

5. We had hired an architect to determine our space need, and this site met the specifications that were determined appropriate.

For these reasons The Arc of Montgomery County's Board of Directors and the Board of Directors of its subsidiaries fully supported the purchase of a new facility.

Recommendations on the Building (page 7 of the draft audit letter)

1. We disagree with BFO's recommendation to have capitalized costs related to architect fees and attorney's fees prior to July 1, 2006, because BFO's recommendation is not consistent with standard accounting practices.
2. We concur with BFO's recommendation that Montgomery County ensure efficient use of the building space at MARC. We believe that our utilization of our space is efficient. As stated above, we are seeking to lease unused space.
3. We reiterate that The Arc of Montgomery County is willing to support BFO's recommendation that Montgomery County conduct a fair market appraisal for reimbursement of the space as rental space. We have done research and a fair market rate in Montgomery County is $18 - $24 a square foot, and we would support a $20 square foot reimbursement for space utilized by the early intervention program.

Issue No. 2 – Questioned Costs ($86,936)

We have significant concerns over some of the questionable costs mentioned in your report. We believe strongly that the following criteria need to apply to any questionable costs:

1. Questionable costs should be limited to those prohibited by the 4300 Regulations. We need to be notified by the Commonwealth of the regulations that state that certain expenditures are not appropriate. We believe that for several of your questionable costs, we are being held to criteria of which we had no notice.
2. Any criteria to which MARC Children's Services is held must be the same standards to which other early intervention providers are held. Federal requirements under waiver require choice in portability of services. Different requirements of providers will mean that the State is unable to guarantee the portability of services required by CMS. Basic issues of fairness, as well as federal regulatory implications, require that BFO deal with agencies in a standard manner.

Expenses Related To New Building – ($37,658)

As indicated to you earlier in this letter, prior to July 1, 2006 we did not have an enforceable agreement for purchasing this facility. From April 12, 2006, to July 1, 2006, we had a due diligence period in which there was no guarantee that the expenses incurred in doing the due diligence would result in the purchase of a new facility. Costs prior to April 1, 2006 were of an investigatory nature and also included costs related to decisions of whether to purchase another facility. The Arc of Montgomery County and MARC Children's Services believe strongly that these expenses should not be capitalized.

Government Affairs Activities – ($19,259)

MARC Children's Services and The Arc of Montgomery County are firmly committed to parent empowerment and family centered planning processes for people with disabilities. As part of this process, we provide numerous trainings to families throughout Montgomery County. Montgomery County has supported these endeavors by distributing training materials to all families whose child receive services in Montgomery County.

We concur with the auditors that a portion of the $10,000 donation that was made to The Arc of Pennsylvania was inappropriately allocated by The Arc of Montgomery County's controller to the early intervention program and believe that a $9,400 adjustment needs to be made.

Costs Unrelated to EI Services – ($30,019)

We concur with two of the adjustments, and we oppose two of the adjustments. Our positions are as follows:

- Toy Grant ($2,000) – We concur that because of an error of The Arc of Montgomery County's previous controller, the $2,000 grant was inappropriately allocated. We believe that a cost settlement needs to occur.

- An extra month of credit card purchases was included in the fiscal period examined ($6,359) – We concur that an extra month of credit card purchases were included in the fiscal period of $6,359. This was an error by the controller, and a cost settlement is appropriate.

- Meals ($7,347) - The question of expenditures for meals and food we find inappropriate. We are unaware of any prohibitions for the purchase of meals in the 4300 regulations. We were never informed by the County or the State that these types of expenditures were inappropriate. As indicated earlier, we believe that if it is a permissible expense under the 4300 regulations and if we did not receive any guidelines or directions concerning the matter, and if the State is not consistently applying standards to other providers, we do not believe it is appropriate to have cost settlement adjustments. DAR indicated that it would be holding MARC to the same standards that apply to State employees. Again, in many of my volunteer positions with the State, the State has provided lunch for me, hotel stay, and travel reimbursement. We believe that the expenses related to meals should be permitted and that there is no cost settlement necessary. If the State does have a regulation which disallows such expenses, please provide it.

- Staff meetings, parties and gifts ($14,313) – We have never been given notification or guidelines concerning this. We certainly would comply with any guidelines that were given to us. We believe that if we are required to follow a new guideline, the State needs to issue it in writing and apply it only to future activity. We are aware of other providers who make similar reimbursements. It should be noted that we purchase flowers or food as gifts when a child who receives services from Marc Children Services dies. This seems to be an appropriate expense. We believe that these expenses are permitted under the 4300 regulations, and that there should be no cost settlement.

Recommendations on Questioned Costs (pages 9-10 of the draft audit letter)

1. We believe that Montgomery County should do a cost settlement with MARC for $4,458 which is a correction on credit card purchases, a $2,000 correction for the toy grant, and a $9,400 related to a gift of The Arc of Montgomery County. We believe that Montgomery County should not require repayment for the expenses.

2. With respect to future activity, DPW should distribute standards regarding unallowable expenses to all providers of early intervention in the State. We believe that it is inappropriate to hold some providers to certain standards, simply because an audit was performed, and not hold all providers to those standards. We further believe that it is inappropriate for Montgomery County to enforce State standards that are not commonly applied in other counties.

Issue No. 3 – Marc Had Excess Retained Revenues For Three Fiscal Periods Totaling $265,893

The Montgomery County Office of Mental Retardation had approved our retaining revenue of over 3%, and we should not have been, or continue to be, required to pay additional revenue back to the County Office of Mental Retardation.

During numerous meetings with the County MR Administrator, we were informed that the retained revenue provisions of Chapter 4300 did not apply because of Section 4300.115(a). The question of retained revenue over 3% was discussed at budget meetings, and the County indicated that we were permitted to retain over 3% revenue. We had regularly requested increased funding from the Montgomery County Office of Mental Retardation to cover our expenses and our 3% retained revenue. After making several of these requests the County reimbursed for greater than our request. When we informed the MR Administrator that this placed us over the 3% retained revenue limit in our contract we were told again that this was not a problem because of Section 4300.115(a) of the 4300 Regulations.

§4300.115 Department established fees.

(a) Rates or fees per unit of service may be published as a Departmental bulletin by the Department for selected services. These published fees are considered to be a reasonable cost for the services covered by the fee schedules. They represent the maximum amount in which the Department will participate for the identified services. *When payment is based on established fees, the county/joinder and provider are not required to negotiate or determine unit costs based on the allowable cost standards in §§4300.82-4300.108.*

As a result of this approval, we believe that we should be able to retain the retained revenue for fiscal year 2003, 2004, 2004/2005, and 2005/2006 of $189,939 calculated by the Bureau of Financial Operations.

The calculation of retained revenue has been extremely fluid by the County Office of Mental Retardation, and although we have disagreed with their calculations, we have reimbursed them every time they have requested reimbursement for excess revenue over expenses.

We calculated for fiscal year 2004/2005 excess over retained revenue of $82,897. The County informed us that they believed it was $94,486. We disagreed with their calculation of these figures. However we reimbursed them $94,486. Later the County indicated that we owed an additional $8,685 as a result of the DPW audit for 2004/2005. Again, we immediately reimbursed the County for those expenses. In October, we requested that we be able to maintain what we projected at that time before our audit was finalized $177,642 over retained revenue for purchase of a new facility. Montgomery County never responded to that request. However in February of 2007, they requested that we reimburse them $164,418 of excess revenue over 3%. We immediately reimbursed them those funds and indicated to them that our calculations on retained revenue owed was $176,238 not $164,418.

Given this history, we have no idea how the County is calculating the 3% (additional) retained revenue, and we are concerned that this figure seems to change regularly. We would appreciate the County approving the additional retained revenue that we requested.

<u>Recommendations on Retained Revenue (Page 10-11 of draft audit report)</u>

We believe that there needs to be clarification on the 3% limit. We also believe that there are funding streams for early intervention that we provide that are not subject to the 4300 Regulations, such as funding from Intermediate Unit, and we should be able to retain net on the provision of those services. We have responded to every request for retained revenue reimbursement. We would presume that our auditors' determination on retained revenue is accurate. Thus, we do believe that the County should reimburse MARC Children's Services $20,274 that was permissible retained revenue under the 3% for 2004/2005. If Montgomery County will not permit excess retained revenue to be used for the purchase of the new facility, that we may need to reimburse $11,820 for fiscal year 2005/2006.

Response to Observation – <u>The Purchase of The Building May Affect The Arc of Montgomery County's Ability To Provide EI Services</u>

We concur that The Arc of Montgomery County continues to face sizable cash flow issues. Over the long term, the purchase of the new facility will increase our asset base, which will permit us to have a larger line of credit that will enable us to meet our cash flow needs.

We further agree with BFO that we have experienced major delays in funding of our early intervention program. It is not unusual that we are reimbursed for May and June services in October and November, and we have been reimbursed for May and June services as late as February in the following year. We believe that delays in payment put not only MARC Children's Services in jeopardy but many early intervention providers. We are very concerned that Montgomery County, because of under allocations by the State, is unable to fund providers at appropriate levels. A specific example of this is that our expense projected for Montgomery County for fiscal year 2006/2007 was $4,566,850, and our contract was for $2,974,788. The

County continued to refer us new cases even after the limit was reached. Typically, once we reach our contract cap, it is months before new contract agreements are assigned, and reimbursement begins.

We also would indicate we were very surprised that in January, 2007, we were notified by the County that it was concerned about the County's potential inability to support the costs related to MARC Children's Services and the new facility. At that point in time, if we would have not moved ahead with the closing on February 1, 2007, we would have lost $500,000 that we had been given as a down payment. It should be indicated also that the County was well informed about our desire and efforts to purchase the new facility, and it was clear in our discussions that we would be making appropriate expense allocations to MARC Children's Services. The administrative staff at the County made no objection or questions concerning our desire to purchase a new facility.

We believe that Montgomery County should not require MARC Children's Services to refund the agreed upon cost settlement of $17,759 related to the toy grant, credit card purchases, and gift to The Arc of Pennsylvania. We believe that Montgomery County should reimburse MARC $20,274 for funds paid back to the County that is revenue that was within the 3% limitation for 2004/2005. If Montgomery County does not permits The Arc of Montgomery County to retain $176,238 of revenue that was in excess of the 3% cap for fiscal year 2005/2006 for the purchase of the new facility. We would recommend that the County not require the return of $16,836 of revenue in excess of 3% for fiscal year 2003/2004.

As indicated, we believe the cost settlement concerning meals, staff meetings, and governmental affairs activities, and expenses related to the building were appropriate, and there should not be any cost settlement process for those expenses.

We also are requesting an exit interview so that we can discuss our recommended changes in our findings.

Sincerely,

Paul Stengle

Paul Stengle
Executive Director

cc: Daniel Higgins
Harriet Dichter
Maureen Cronin
Joseph Roynan
Eric Goldstein
Todd Klunk
John H. Bungo