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

JUN 14 2007

TELEPHONE NUMBER
(717) 787-9200
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JOHN H. BUNGO, CGFM, CFS
DIRECTOR

Mr. Charles McClanahan, Executive Director
There's Room in the Inn, Incorporated
444 Plessinger Road
Warfordsburg, Pennsylvania 17267-7906

Dear Mr. McClanahan:

Enclosed is the final review report of your Agency 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 Children, Youth and Families to begin the Department's resolution process concerning the report contents. The staff from the Office of Children, Youth and Families 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 Richard E. Wessel, Audit Manager of the Western Field Office, at (412) 565-2187.

Sincerely,

John H. Bungo

John H. Bungo, CGFM, CFS

Enclosure

cc: Mr. Richard Gold
Mr. Andrew Major
Ms. Kathryn Bard

COMMONWEALTH OF PENNSYLVANIA
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JOHN H. BUNGO, CGFM, CFS
DIRECTOR

Mr. Richard Gold, Deputy Secretary
Office of Children, Youth and Families
131 Health and Welfare Building
Harrisburg, Pennsylvania 17105

Dear Mr. Gold:

In response to a request from your Central Region Director, the Bureau of Financial Operations (BFO) conducted a performance audit of There's Room in the Inn, Incorporated (TRI). The BFO's mission, accomplished through its audit and review activities, is to assist Department of Public Welfare (DPW) management to administer human service programs of the highest quality at the lowest cost with integrity.

The audit request indicated concern regarding the use of budgeted funds for improvements to the Executive Director's personal residence.

Background:

TRI is a residential therapeutic facility for delinquent and dependent youths formed as a Pennsylvania non-profit corporation in 1993. In 2001, it was licensed by DPW and began to serve delinquent youths referred by Pennsylvania counties. Its facility is located in a near-wilderness setting on a 70 acre site close to State Game Lands #65. The TRI program description addresses:

- Character development,
- Life-skill development,
- Education at its on-campus, approved Alternative Education School,
- Vocational instruction, and
- Equine Program

The target length-of-stay at this 21-bed facility is six months.

The unaudited January 2007 financial statements indicated it has recognized revenue for the seven months ended January 31, 2007 as follows:

Background (Continued):

School	$ 111,575
Counties	413,183
Private clients	48,207
Contributions	122,339
Miscellaneous	11,961
	$ 707,265

TRI has reported revenue and expenses as follows:

	Revenue	Expense
2002-03	$ 906,287	$ 830,224
2003-04	1,051,893	1,092,730
2004-05	1,175,454	1,141,595
2005-06 (unaudited)	993,336	950,824

TRI declined to participate in the Medical Assistance realignment. Management believes that this caused referrals from counties to decline sharply in 2005-06. Accordingly, TRI marketed its services to the private sector and sought increased contributions. Although they did not fully offset the decline in revenue from the Counties, both efforts were successful.

Objective, Scope and Methodology:

Our audit addressed the following objective:

> To determine the nature of costs charged to county children and youth agencies by There's Room in the Inn, Incorporated.

The scope of our audit was limited to those procedures deemed necessary to accomplish this objective. In pursuit of the objective, we interviewed management staff. We also reviewed contracts, independent audit reports, corporate records, budget and rate submissions, and other accounting records.

Government auditing standards require that the BFO 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 compliance with generally accepted accounting

<u>Objective, Scope and Methodology (Continued):</u>

principles. Based on the BFO understanding of the controls, no significant deficiencies came to our attention other than those described in this report.

Our fieldwork, conducted from February 12 through February 15, 2007, was performed in accordance with generally accepted government auditing standards. This report, when presented in its final form, is available for public inspection.

<u>Results of Fieldwork:</u>

The TRI per diem rate is not established by budget negotiation. Instead, the Agency's major customers indicate how much they will pay and TRI submits a budget supporting that figure. As a result of this process, TRI's rate has been unchanged at $125 per day since they began serving public clients. This rate is charged to all residents, public and private.

Counties and private clients pay TRI a rate that is significantly less than full reimbursement of the organization's cost. Approximately 15% of the cost to operate the program during 2004-05 was funded by cash contributions from private donors. In addition to cash, individuals and businesses have donated building equipment and materials, labor, food, services, and real estate.

The request for this audit referred to the Executive Director as the "owner/CEO" of TRI. This is technically incorrect; he is the Executive Director of a non-profit, 501(c)3 corporation whose net assets upon dissolution must be distributed to a similar entity. However, the TRI corporate culture does resemble a personally owned for-profit entity. Some corporate documents and literature refer to the Executive Director as the "Founder."

In addition to a salary, TRI provides the Executive Director with a house and two vehicles. All are titled to TRI and to some extent are used in furthering the Agency's mission. The residents are frequent guests in the house and are often transported in the vehicles. A further benefit to the Executive Director is addressed in Issue No. 1. Issue No. 2 addresses an aspect of the TRI management structure that has nurtured the peculiar corporate culture.

Issue No. 1 – <u>Loans to Employees</u>

TRI has extended minimally documented loans to senior company officials. In one circumstance, collection may be in doubt. The other may jeopardize the Agency's tax exempt status.

Results of Fieldwork (Continued):

TRI extended a $10,000 loan to a now-former employee. In 2003, management recruited a program director that had to relocate. TRI lent him the money with the understanding that he would repay at the rate of $40 per month until he sold his house in the Pittsburgh area when he would pay off the entire amount. A document dated July 11, 2003, and signed by the individual and the Executive Director indicates that the monthly payments constitute interest. The individual who is no longer employed by TRI continues to make the monthly payments. Management does not know the current status of the house, but the Executive Director indicated he has maintained contact and will move toward resolving the situation.

The Executive Director borrowed $36,000 from TRI in August, 2006. This loan is currently being repaid at the rate of $500 per month. There is no documentation associated with this loan, except that the Finance Director deducts the standard amount from his salary each month. In the absence of documentation to the contrary, this is presumably an unsecured, interest-free loan.

The "negotiations" associated with the loan illustrate a lax top control environment. The Executive Director asked the other two board members to approve a loan from the corporation. They volunteered to authorize a bonus, but the Executive Director felt that a loan would be more appropriate.

These loans cost TRI both financially and by potentially jeopardizing their 501(c)3 status. The effective annual interest rate on the former employee's loan is 4.8%, compared with the Agency 8.25% rate on its line of credit borrowing. The loan to the Executive Director, with no apparent interest rate, could prove to have negative consequences beyond the interest cost. The Internal Revenue Service (IRS) has stated that:

> No part of an organization's net earnings may inure to the benefit of a shareholder or private individual. This means that a 501(c)3 organization is prohibited from allowing its income or assets to accrue to insiders. The prohibition of inurement is absolute. Any amount will jeopardize the organization's 501(c)3 status.

It indicates that officers, directors, and key employees are examples of "insiders." Furthermore, the IRS requires that in the event of a loan with a below market interest rate, an appropriate rate must be imputed. The variance between the imputed and actual interest is to be reported as income by the borrower. The circumstances associated with the Executive Director's loan appear to violate this requirement.

Results of Fieldwork (Continued):

Recommendations:

The BFO recommends that any future TRI loans to staff reflect interest charged at market levels and be fully documented to include:

- Specific, clear and complete authorization in board minutes; and,
- A document signed by the employee and an authorized corporate official indicating all details of the loan, including a clause stating the corporation's recourse in the event of the employee's termination.

The BFO also recommends that TRI review all of the circumstances regarding its loans to employees and take corrective action to ensure the Agency complies with IRS regulations.

Issue No. 2 – Governing Structure

TRI has a lax top control environment that appears to permit the Executive Director an imprudent degree of control. The board needs to reorganize its structure and functioning in order to actively promote good governance practices and protect against the substance and/or appearance of conflict of interest.

TRI has a three-person board, including the Executive Director and two individuals who appear to be personally loyal to him. Recently, it has only met four times per year, often away from the facility. There has recently been little regular interaction between board members and Agency staff other than the Executive Director. Board authorizations and instructions are generally not clearly documented in board minutes.

Regulatory authorities provide guidance regarding appropriate structure and functioning of charitable organizations' governing boards. Pennsylvania Attorney General "Investigates and initiates legal actions against charitable organizations ... to ensure that charitable donations are lawfully .. expended."

The Attorney General's "Handbook for Charitable Nonprofit Organizations" provides board members and senior management with basic information. The IRS, in accordance with its premise, "... that governing boards should be composed of people who are informed and active in overseeing a charities' operations and finances ..." has recently issued an exposure draft entitled Good Governance Practices for (501)(c)(3) Organizations."

Results of Fieldwork (Continued):

The first action TRI needs to take to promote good governance practices is to expand the Board's size to seven members as authorized by its bylaws. The IRS indicates that, "Organizations with very small ... governing boards may be problematic: small boards generally do not represent a public interest ..." The Better Business Bureau's "Standards for Charity Accountability" require an absolute minimum of five voting members. Although the Pennsylvania Attorney General does not address board size, the "Handbook for Charitable Nonprofit Organizations" addresses a related concern that speaks to the TRI situation. It states that, "In order to avoid the appearance of impropriety, it is best not to give one individual too much control over the corporation." Accordingly, TRI should aggressively recruit new board members, reflecting a broader range of abilities and public interests.

Conflict of Interest

Both the IRS and the Pennsylvania Attorney General address the need for entities such as TRI to guard against conflicts of interest. The IRS states that, "... the duty of loyalty requires a (board member) to avoid conflicts of interest that are detrimental to the charity." The Attorney General indicates that, "Board members and senior management have a duty to avoid potential or apparent conflicts of interest." TRI can comply by establishing a conflict of interest policy that:

- Requires directors and staff to act solely in the organization's tax exempt interest;
- Includes written procedures for determining whether a relationship, financial interest, or business affiliation results in a conflict; and,
- Prescribes a certain course of action in the event a conflict of interest is identified.

The Auditor General indicates that, "An individual who has a potential conflict with respect to a particular transaction should ... abstain from participating in the negotiations and decisions surrounding the transaction." He adds that, "To avoid the appearance of impropriety, the individual who has the conflict of interest should not be present in the room during any discussions that relate to the transaction." These recommendations should be reflected in the TRI policy and practice.

Results of Fieldwork (Continued):

Executive Compensation

The Attorney General advises that compensation, which includes salaries, benefits, gifts, living expenses, and all other items of value, must not be excessive. He further states that:

> The level of compensation that is to be paid to each individual should be determined by the board of directors or a committee vested with the authority to set compensation. Individual employees should not be involved in setting their own compensation. In determining whether compensation is reasonable, the salary ranges of similarly situated individuals in similar nonprofit organizations should be examined.

These recommendations apply to all employees, but are particularly pertinent for the Executive Director's compensation.

Performance Review

Both the IRS and the Attorney General stress the importance of a charity's board exercising due diligence. Accordingly, it is appropriate that they monitor and critically review the Executive Director's performance. The "Standards for Charitable Accountability" recommends that the board of directors conduct and document a formal review of the Executive Director's performance at least once every two years.

Code of Ethics

The IRS has addressed the advisability of codes of ethics and whistleblower policies as follows:

> The public expects a charity to abide by ethical standards that promote the public good. The board of directors bears the ultimate responsibility for setting ethical standards and ensuring they permeate the organization and inform its practices. To that end, the board should consider adopting and regularly evaluating a code of ethics that describes behavior it wants to encourage and behavior it wants to discourage. The code of ethics should be a principal means of communicating to all personnel a strong culture of legal compliance and ethical integrity.

Results of Fieldwork (Continued):

> The board of directors should adopt an effective policy for handling employee complaints and establish procedures for employees to report in confidence suspected financial impropriety or misuse of the charity's resources. Such policies are sometimes referred to as *whistleblower* policies.

Both a code of ethics and a whistleblower policy would help the TRI board to fulfill its fiduciary responsibilities.

Board Structure and Procedures

TRI needs to change its board structure and procedures to further inform members regarding the facility's operations and enhance the board's own operational efficiency. Appropriate structural changes would be organizing into committees and authorizing agency staff to provide support services directly to the board and its committees. Suitable procedural changes would be to increase the frequency of meetings, meet at the facility, and clearly document the board's decisions.

The TRI board could facilitate its members' informed management of the Corporation's business by organizing into committees to address specific aspects of the operation. This would enable members to use their expertise and interests efficiently and significantly increase their expertise. The Board's standing committees might include ones dealing with finances, personnel, program, and fundraising. It may also establish ad hoc committees to address specific issues as they arise. The board as a whole should designate committee tasks and membership. The various committees should regularly report to the board regarding their progress and concerns.

Even a significantly enlarged board efficiently organized into committees could find the effective management of the Agency to be a daunting task. Accordingly, TRI should consider assigning Agency employees to provide staff support directly to the board and its committees. One example of appropriate staff support would be for the fiscal/human resources director to work with the finance and personnel committees. Another would be for the program director to work with the program committee. The emphasis should be on making staff members' particular expertise and knowledge of the Agency's inner workings available to the other committee members.

The Executive Director provides board members with periodic reports that are informative and well-written. However, the current, quarterly schedule of

Results of Fieldwork (Continued):

meetings does not contribute toward members achieving a full and objective understanding of the Agency's affairs and finances. Many organizations similar to TRI find that a monthly meeting schedule is appropriate. Some others have infrequent board meetings but meet often as committees. The actual timing of the meeting is up to the board, but the IRS states that the organization's policies and procedures should ensure that each member:

- Is familiar with the charity's activities and knows whether those activities promote the charity's mission and achieve its goals;
- Is fully informed about the charity's financial status; and
- Has full and accurate information to make informed decisions.

The meetings need to be frequent enough to comply with this directive.

TRI could further enhance board members' familiarity with the Agency's functioning by holding its meetings at the TRI site. These meetings could be held in conjunction with facility tours, interaction with staff and residents, and similar experiences. Board involvement at the site could have benefits beyond educating the members. TRI has an exciting program; this could attract potential board members and inspire their efforts on the Agency's behalf.

Increasing the frequency of board meetings and holding them at the TRI site are recommended changes. Improving the quality of the minutes is mandatory. Currently, board minutes do not clearly state the board decisions or document the instructions to the Executive Director. The preparation of minutes may be improved by having TRI clerical staff attend the meetings, take the minutes, and after the board secretary's approval, distribute them to members.

Recommendations:

The BFO recommends that the TRI Board:

- Increase its size to seven members as authorized by its bylaws;
- Develop and implement conflict of interest policy;
- Determine reasonable executive compensation in the absence of the individual involved;
- Conduct formal biannual reviews of the Executive Director's performance; and,
- Implement a code of ethics and a whistleblower policy.

Results of Fieldwork (Continued):

The BFO also recommends that the TRI Board organize into committees to address specific corporate functions.

The BFO further recommends that the TRI Board make use of Agency personnel to staff board committees.

The BFO finally recommends that the TRI Board ensure that its meeting minutes give clear and accurate statements of Board decisions and instructions.

An exit conference was held with TRI management on May 11, 2007.

TRI's response to this report is included as Appendix A.

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

If you have any further questions concerning the audit or if we can be of any further assistance in this matter, please contact Richard Polek, Audit Resolution Section, at (717) 787-6529.

Sincerely,

John H. Bungo

John H. Bungo, CGFM, CFS

cc: Mr. Charles McClanahan
Mr. Andrew Major
Ms. Kathryn Bard

APPENDIX A

AUDITEE'S RESPONSE

THERE'S ROOM IN THE INN
BOYS RANCH ACADEMY

444 Plessinger Rd.
Warfordsburg, PA 17267

Chuck McClanahan
Executive Director
(717) 294-6072

May 16, 2007

Mr. Richard Wessel, CFE
Department of Public Welfare
Bureau of Financial Operations
Western Field Office
701 State Office Building
300 Liberty Avenue
Pittsburgh, PA 15222

Dear Mr. Wessel:

Please find enclosed the plan of action the Board of Director's of There's Room in the Inn, Inc. is taking concerning the following recommendations outlined in your audit report of our program conducted on February 15, 2007.

Employee Loans:

The repayment of the two employee loans has been structured by our bank loan officer to ensure all interest is added to the loans. This will eliminate any IRS issues concerning net earnings may not inure the benefit of a private individual. We also have involved an attorney who is taking steps to place a lien on one of the employee's personal residence to legally ensure repayment when sold. We as a Board have also made the decision to entirely eliminate employee loans in the future. As discovered by your audit county dollars were not used for these loans.

Governing Structure:

Our goal is to increase the present board of three to five members which keeps us in alignment with our organizations bylaws which states board size may consist of three to seven members.

The Board will continue to meet quarterly with in depth documentation of decisions made by the Executive Committee that occur between regular scheduled meetings. More detail will be given to board minutes making sure to clearly define and document decisions and directives voted on.

The following committees will be implemented as recommended in order to enhance the Boards operational efficiency involving Agency staff:

- Finance committee
- Personnel committee
- Program
- Equine
- Academy

A Conflict of Interest policy is being drafted by our attorney and will be implemented when completed.

Executive compensation will be established as advised in report's recommendation.

Executive Director's performance will be reviewed as advised in report's recommendation.

A Code of Ethics and Whistle Blower policy is being drafted by our attorney and will be implemented when completed.

Final Comments:

Your audit report clearly defined areas of concern within our organization that left unattended could easily lend itself to having the "appearance" of mismanagement. However, we as a Board have welcomed your recommendations and agree that implementing them into our already strong non-profit culture will be an asset to us in the future.

Sincerely,

Steve Rowell

Mr. Steve Rowell
President