

OFFICE OF AUDITS & ADVISORY SERVICES



MENTAL HEALTH SYSTEMS SPECIAL REVIEW

FINAL REPORT

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County of San Diego

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April 28, 2016

TO: Thomas Montgomery, County Counsel
Office of County Counsel

FROM: Juan R. Perez
Chief of Audits

FINAL REPORT: MENTAL HEALTH SYSTEMS SPECIAL REVIEW

Enclosed is our report on the Mental Health Systems (MHS) Special Review. The report includes the results of the special review of MHS in relation to the fraud and misconduct allegations, as requested by your office.

If you have any questions, please contact me at (858) 495-5661.

JUAN R. PEREZ
Chief of Audits

AUD:TF:aps

Enclosure

c: Tracy M. Sandoval, Deputy Chief Administrative Officer/Auditor and Controller

WHY OAAS PROVIDED THE SERVICES

Objective

Under the direction and control of the Office of County Counsel (County Counsel), with the assistance from the Health and Human Services Agency Contract Support Unit (ACS) and the Office of Ethics and Compliance (OEC), the Office of Audits & Advisory Services (OAAS) initiated a special review of Mental Health Systems, Inc. (MHS), a County of San Diego (County) contractor. The objective of the special review was to investigate allegations communicated to the County by a complainant. The allegations are as follows:

- Ia/Ib. MHS used funds obtained from State, federal and County cost reimbursement contracts to finance a failed for-profit company called Novata.
- II. MHS's financing of Novata resulted in serious detriment to MHS, its clients, its employees, and its vendors.
- IIIa/IIIb. MHS withheld payments to vendors, contractors, doctors and staff in order to transfer cash to the for-profit.
- IV. MHS billed State, federal, and county contracts for expenses it had not paid.
- V. MHS billed cost reimbursement contracts for consulting services provided by Open Minds.
- VI. There are no significant documented deliverables for services provided by Open Minds.
- VII. Inappropriate relationships exist between Open Minds owner/staff and MHS management.
- VIII. Dr. David Conn, the husband of MHS's President, sits on the advisory board of Open Minds.
- IX. The MHS Board approved Dr. David Conn's appointment to a highly compensated position that reports directly to Kimberly Bond, his wife (MHS's President & CEO).

This special review was conducted in conformance with the Certified Fraud Examiners' Code of Professional Standards prescribed by the Association of Certified Fraud Examiners.

Background

MHS is a non-profit agency founded in 1978. Through administration of various programs and primarily pursuant to government contracts, MHS provides mental health services, drug and alcohol rehabilitation services, vocational rehabilitation services, and educational programs to individuals, families, and communities. Table 1 summarizes MHS's current contracts with the County.

Table 1. Current MHS Contracts for FY 2015-16

| County Department | Number of Contracts | Annual Authorized Amount | Contracts Terms |
|---|---------------------|--------------------------|----------------------------|
| Health and Human Services (HHS) | 27 | \$35,733,737 | Jul 1, 2000 - Jun 30, 2021 |
| Probation | 1 | \$901,867 | Jul 1, 2014 - Jun 30, 2021 |
| Housing and Community Development (HCD) | 3 | \$230,822 | Jul 1, 2011 - Jun 30, 2016 |
| Total | 31 | \$36,866,426 | |

MHS submits claim forms to the County to get reimbursed for services provided pursuant to the County contracts. Claim forms include direct and indirect expenditures incurred by MHS. Indirect expenditures are charged to the County by applying MHS's indirect rate to the direct program expenditures. According to MHS's Cost Allocation Plan, the indirect rate charged to the County in FY 2014-15 and FY 2015-16 was 13.5% and 14.5%, respectively.¹ Table 2 outlines direct and indirect expenditures paid by the County to MHS in FY 2014-15 and FY 2015-16.²

Table 2. Direct and Indirect Expenditures Paid by the County

| Department | Direct Expenditures | | Indirect Expenditures | |
|--------------|---------------------|---------------------|-----------------------|--------------------|
| | FY 2014-15 | FY 2015-16 to Date | FY 2014-15 | FY 2015-16 to Date |
| HHS | \$32,075,657 | \$17,829,907 | \$3,538,089 | \$2,024,907 |
| Probation | \$719,746 | \$535,909 | - | - |
| HCD | \$251,923 | \$241,107 | \$9,162 | \$9,000 |
| Total | \$33,047,326 | \$18,606,923 | \$3,547,251 | \$2,033,907 |

Each County department reviews claims submitted by MHS prior to payment and is responsible for ensuring the contractor is in compliance with contract requirements, services are being delivered at an acceptable level of quality, outcomes and objectives are on-track to be met or have been met, and the contracted program is having the anticipated impact on the target population. This occurs in a variety of ways throughout the contract year including claim (invoice) reviews, site visits, reviews of performance data, quality assurance reviews, in-depth invoice reviews and reviews of contract deliverables.

In 2010, MHS created a for-profit subsidiary, named Behavioral Healthcare Solutions (BHS), to segregate government and nongovernment funding. In October 2013, BHS purchased the Center for Autism Research, Evaluation & Service, a Psychological Corporation (CARES). Shortly after the purchase, the name of BHS was changed to Novata Behavioral Health (Novata). Novata is a wholly-owned, for-profit subsidiary of MHS. MHS and Novata share the same board of directors and management team.

¹ The County is charged an indirect rate by MHS based upon its provisional federal rate. That provisional rate ended on June 30, 2015. MHS was unable to confirm that it received government approval of the final rate. As a result, the County is in the process of calculating MHS's proper indirect rate for FY 2013-14 to FY 2014-15.

² HHS payments are as of January 31, 2016. Probation payments are as of February 29, 2016. HCD payments are as of March 31, 2016.

Novata provides treatment and support services for children and families living with autism and other neurodevelopmental disorders.

Based on information provided by MHS, MHS engaged Open Minds, a Pennsylvania based company, in FY 2010-11 to provide consulting services related to market intelligence and management information.

Methodology

OAAS performed its investigation using the following methods:

- Interviewed the complainant to obtain an understanding of the allegations.
- Interviewed MHS's key personnel on policies, procedures, and processes to investigate allegations made by the complainant.
- Reviewed MHS's financial statements and supporting schedules.
- Reviewed MHS's proposed federal indirect rate calculation.
- Analyzed the financial condition of MHS and Novata.
- Confirmed with a random sample of MHS's vendors and subcontractors their receipt of checks and MHS's payment practices.
- Reviewed MHS's payment history to Open Minds and related contracts.
- Reviewed MHS's HR and payroll documents related to David Conn's position and compensation at MHS.
- Obtained results of the work conducted by ACS.

Terms Definition

The terms applied to the investigation results are defined as follows:

Substantiated: The allegation is accurate and was validated through the investigation.

Substantiated – Corrective Action Taken: The allegation is accurate and was validated through the investigation. Corrective action(s) to address identified issues have been implemented.

Partially Substantiated: Some elements of the allegation are accurate. Verification was partial where it was concluded that one or more, but not all of the allegations, were substantiated.

Unsubstantiated: The allegation is false or invalid based on the investigation performed.

Inconclusive: The validity and/or accuracy of the allegation cannot be determined due to lack of supporting documentation or because under the terms of the contract, the County lacks access rights to the necessary information.

Summary of Investigation Results

Within the scope of the special review, OAAS concluded the following:

Table 3. Summary of Results

| Conclusion | Allegations |
|---|-------------|
| Substantiated | 2 |
| Substantiated - Corrective Action Taken | 1 |
| Partially Substantiated | 4 |
| Unsubstantiated | 1 |
| Inconclusive | 3 |

In addition to the investigation results, OAAS identified several operational issues, identified in this report as “Findings” that should be addressed by MHS.

The investigation results for each allegation are detailed below.

Complainant’s Allegation I:

Use of Government Funds to Finance Novata

Allegation: For the past two years, MHS has been using funds obtained from State, federal and county cost reimbursement contracts to finance a failed for-profit company called Novata.

For purposes of clarity, the investigation results of this allegation were divided into two parts:

Allegation Ia: MHS financed a for-profit company called Novata.

Allegation Ib: MHS has been using funds obtained from State, federal and county cost reimbursement contracts to finance Novata.

1a. Substantiated

OAAS’s investigation found that MHS has transferred funds to Novata since FY 2013-14, as summarized in Table 4.

Table 4. MHS Transactions with Novata as of December 31, 2015

| Fiscal Year | MHS Cash Transferred to Novata | Novata’s Expenses Paid by MHS | MHS Services Provided to Novata | Payments Received from Novata | Receivable Balance Due from Novata |
|--------------|--------------------------------|-------------------------------|---------------------------------|-------------------------------|------------------------------------|
| FY 2013-14 | \$1,710,000 | \$894,955 | \$736 | - | \$2,605,691 |
| FY 2014-15 | \$3,464,000 | \$287,509 | \$971,873 | \$1,590,302 | \$5,738,770 |
| FY 2015-16 | \$250,834 | \$225,266 | \$229,461 | \$784,585 | \$5,659,748 |
| Total | \$5,424,834 | \$1,407,730 | \$1,202,070 | \$2,374,866 | |

While Novata is not a “failed” for-profit company as alleged, an analysis of Novata’s financial statements identified a poor financial condition, as illustrated in Table 5.

Table 5. Novata's Financial Position as of December 31, 2015

| Description | Balance |
|--|----------------------|
| Current Assets | |
| Cash | \$387,038 |
| Accounts Receivable, net of allowance | \$2,268,930 |
| Other Current Assets | \$48,028 |
| Total Current Assets | \$2,703,996 |
| Non-Current Assets | |
| Fixed Assets, net of depreciation | \$141,681 |
| Goodwill, net of impairment | \$1,970,015 |
| Deferred Tax | \$1,728,334 |
| Other Non-Current Assets | \$39,085 |
| Total Non-Current Assets | \$3,879,115 |
| Total Assets | \$6,583,111 |
| Total Current Liabilities | \$1,617,445 |
| Total Long-Term Liabilities³ | \$8,128,883 |
| Stockholder's Equity | (\$3,163,216) |

OAAS noted that transferred funds were recorded as account receivables on MHS's financial statements and as liabilities on Novata's financial statements.

In order to secure a loan to acquire CARES, MHS entered into a Support and Guaranty Agreement with a bank, which required MHS to deposit funds into Novata's accounts when Novata is not in compliance with its Debt Service Coverage Ratio and loan obligations.

According to MHS's management, transferred funds were used to cover Novata's payroll obligations and program expenses. Some funds were used for a technology upgrade and start-up costs related to the purchase of CARES. In addition, MHS paid certain expenses on behalf of Novata.

On October 17, 2011, MHS established an agreement with BHS (now named Novata) whereby MHS provides accounting, administrative and management services to Novata. MHS charges Novata a monthly fee of 10% of Novata's revenue for the services provided. (See Finding IV).

Impact to the County: Funds transferred to Novata have impacted MHS's ability to pay its financial obligations which increases the risk that MHS's vendors and subcontractors may not be paid in accordance with County contract terms. This can also impact services provided to the County. Further, Novata's poor financial condition increases the risk that its obligations will not be repaid, thereby its financial condition can potentially worsen.

1b. Inconclusive

OAAS was not able to determine which specific funding sources were used to finance Novata's operations, because transfers from

³ Total long-term liabilities include \$5,659,748 owed to MHS.

MHS to Novata were processed from MHS's cash account which commingles funds from different sources. MHS's accounting procedures do not allow for tracing of the cash transferred to Novata back to the original funding source.

OAAS analyzed MHS's revenue for FY 2014-15, as summarized in Table 6, and noted that the majority of MHS's revenue is obtained from government sources.

Table 6. MHS Revenue FY 2014-15

| Revenue Source | Direct Revenue | Pass-Through Federal Funds | Total Revenue | % |
|---------------------|---------------------|----------------------------|---------------------------|-------------|
| Federal Government | \$601,662 | - | \$601,662 | 1% |
| State Government | \$16,080,021 | \$706,476 | \$16,786,497 | 22% |
| County of San Diego | \$35,721,910 | \$3,817,447 | \$39,539,357 ⁴ | 52% |
| Other Counties | \$9,957,397 | \$6,346,721 | \$16,304,118 | 22% |
| Non-government | \$2,244,091 | - | \$2,244,091 | 3% |
| Total | \$64,605,081 | \$10,870,644 | \$75,475,725 | 100% |

However, in addition to the revenues identified above, MHS also had an \$8 million line of credit that could potentially have been used to finance Novata's operations.

Impact to the County: Impact cannot be determined as it is unknown whether County funds were used to finance Novata.

Complainant's Allegation II:

Impact of Cash Transfers to Novata

Allegation: Use of funds to finance Novata has been done to the serious detriment of MHS, its clients, its employees and its vendors.

Partially Substantiated

OAAS did not quantify the specific detriment caused to MHS clients or employees; however, OAAS determined that funds transferred to Novata have impacted MHS's ability to pay its financial obligations.

OAAS verified that MHS's cash balance, as of January 31, 2016, is insufficient to cover its current liabilities as outlined in Table 7. However, its overall financial position as of the same date appears adequate if all receivables, including those due from Novata, are collected.⁵

⁴ Revenue amount recorded by MHS varies from County expenditures presented in Table 2 due to timing differences.

⁵ Additional financial information received by OAAS during the report writing process indicates that for the nine months ending March 31, 2016, MHS has incurred a net loss of \$3,163,048.

Table 7. MHS Financial Position as of January 31, 2016

| Description | Total Balance |
|--|---------------------|
| Liquid Assets | |
| Cash | \$1,285,571 |
| Total Liquid Assets | \$1,285,571 |
| Current Assets | |
| Contracts Receivable, net of allowance | \$13,274,621 |
| Other Receivables ⁶ | \$5,680,348 |
| Other Current Assets | \$791,114 |
| Total Current Assets | \$19,746,083 |
| Non Current Assets | |
| Fixed Assets, net of depreciation | \$13,190,398 |
| Other Non Current assets | \$881,465 |
| Total Non Current Assets | \$14,071,863 |
| Current Liabilities | |
| Accounts Payable | \$2,817,410 |
| Accrued Payroll and Related Taxes | \$1,288,753 |
| Accrued Employee Benefits | \$5,319,405 |
| Other Current Liabilities ⁷ | \$6,203,128 |
| Total Current Liabilities | \$15,628,696 |
| Total Long-Term Liabilities | \$8,459,333 |
| Total Net Assets | \$11,015,487 |

Additionally, OAAS randomly selected invoices and mailed confirmation letters to 48 vendors and subcontractors to identify MHS's payment practices. We received responses from 31 vendors and subcontractors; 11 confirmed that MHS does not consistently pay in a timely manner (in accordance with their own invoice terms).

Also, based on interviews with MHS management and a review of applicable documents, OAAS confirmed that MHS does not pay all invoices by their due dates. According to the management staff interviewed, invoices with high priority such as rent, utilities, payments to psychiatrists, and certain program expenses are processed on a weekly basis. When asked which gets priority - MHS's vendor invoices or making required cash transfers to Novata - MHS's CEO stated that MHS's vendor invoices are paid first.

However, pursuant to the Support and Guaranty Agreement signed with the bank, MHS is legally required to provide cash when Novata is not in compliance with its Debt Service Coverage Ratio and loan obligations.

Impact to the County: An insufficient cash balance increases the risk that MHS's vendors and subcontractors will not be paid in accordance with County contract terms which can impact services provided to the County.

⁶ Other Receivables refers to Novata Receivables.

⁷ Other Current Liabilities include MHS's current portion of line of credit, unearned revenue, and other miscellaneous liabilities.

Complainant's Allegation III:

Withholding Payments to Vendors and Subcontractors in Order to Subsidize Novata

Allegation: For the past seven months, MHS has withheld payments to vendors, contractors, doctors and staff in order to transfer cash to the for-profit.

For purposes of clarity, the investigation results of this allegation were divided into two parts:

Allegation IIIa: Payments to vendors, contractors, doctors and staff have been withheld.

Allegation IIIb: Withheld payments were used to transfer cash to Novata.

IIIa. Substantiated – Corrective Action Taken

Through inquiries made to MHS's management and accounts payable staff, OAAS confirmed that MHS withheld payment checks to vendors and subcontractors. While MHS prepared checks for all invoices received on a weekly basis, not all of the checks were released when written.

OAAS confirmed that in January, 2016, MHS held 165 checks totaling \$1,376,568; 160 of these checks were prepared in January, 2016, and 5 checks were prepared in October and December, 2015. Out of 165 checks held in January, 2016, 152 checks were mailed to vendors and subcontractors either in February or March, 2016, and 13 checks were voided⁸ in March, as detailed in Table 8. This practice violates Generally Accepted Accounting Principles because it results in understated liabilities and cash recorded on the books.⁹

Table 8. Held Checks

| Check Status | Holding Period | Number of Checks | Amount |
|----------------------------|----------------|------------------|--------------------|
| Mailed | 8-20 days | 5 | \$18,895 |
| | 21-30 days | 67 | \$408,576 |
| | 31-40 days | 28 | \$4,900 |
| | 41-44 days | 52 | \$607,348 |
| Total mailed checks | | 152 | \$1,039,719 |
| Voided | 36-56 days | 8 | \$137,425 |
| | 62-132 days | 5 | \$199,424 |
| Total voided checks | | 13 | \$336,849 |
| Total checks | | 165 | \$1,376,568 |

Based on limited testing, OAAS verified that MHS stopped holding checks in February, 2016.

⁸ Out of 13 voided checks, 7 checks were reissued in March 2016.

⁹ Since checks were not mailed to vendors and subcontractors, the amount of cash in MHS's bank account was not affected.

Impact to the County: According to specific provisions in County contracts, MHS was required to comply with Generally Accepted Accounting Principles and good business practices. By withholding checks made out to vendors and subcontractors, MHS was violating those contractual provisions.

IIIb. Inconclusive

While MHS's management acknowledged that checks were withheld due to cash issues, OAAS did not find direct evidence to confirm that payments were withheld because MHS needed the cash to prioritize transfers to Novata specifically.

Impact to the County: Unable to determine.

Complainant's Allegation IV:

Billing for Reimbursable Expenses that Have not Been Paid

Allegation: On any given week, MHS has billed State, federal, and county contracts for anywhere between \$1M and \$4M of cost reimbursable expenses which have not been paid.

Partially Substantiated

Testing to substantiate this allegation was limited to County funds only. As such, the allegation is partially substantiated.

ACS obtained the A/P Aging Report as of March 11, 2016 and requested MHS to identify accounts payable attributable to County contracts, as summarized in Table 9.¹⁰

Table 9. A/P Aging Analysis

| A/P Details | Current | 31-60 Days | 61-90 Days | 91 and Over | Totals |
|---------------------------------|---------------------|---------------------|---------------------|---------------------|-----------------------|
| County - Claimed | \$72,324.66 | \$162,747.15 | \$15,447.39 | \$243.39 | \$250,762.59 |
| County - Not Claimed | \$380.09 | \$145,154.70 | \$58,595.59 | \$0.00 | \$204,130.38 |
| Total County Related A/P | \$72,705 | \$307,902 | \$74,043 | \$243.39 | \$454,893 |
| Indirect Costs | \$107,639.53 | \$149,531.64 | \$85,945.03 | \$70,613.28 | \$413,729.48 |
| Non-County | \$490,750.26 | \$296,294.84 | \$12,828.14 | \$182,869.17 | \$982,742.41 |
| Totals | \$671,094.54 | \$753,728.33 | \$172,816.15 | \$253,725.84 | \$1,851,364.86 |
| % of Total Payables | 36% | 41% | 9% | 14% | 100% |

According to MHS's management, \$454,893 of accounts payable are direct expenses attributable to County contracts. Of that amount, \$250,763 has been claimed by MHS to the County while the remaining \$204,130 had not yet been claimed.

From the \$250,763 of accounts payable already billed to the County, \$178,437 are past due over 31 days. MHS's management stated that the County may have not yet paid some of the \$178,437; however no evidence was provided to support this statement.

¹⁰ Due to the time restraints, the accuracy of information presented in Table 9 was not validated by ACS.

Impact to the County: If it is determined that MHS has not paid its vendors and subcontractors for expenses already reimbursed by the County, it constitutes a violation of the “Prompt Payment for Vendors and Subcontractors” term in the County contracts which requires MHS to pay its vendors no later than 30 days after receipt of payment from the County.

Complainant’s Allegation V:

Billing the County for Open Minds Consultants

Allegation: Over the past few years, MHS has billed cost reimbursement contracts for approximately \$1.2M of expenses paid to a consulting firm called Open Minds.

Partially Substantiated

OAAS found that from FY 2010-11 to FY 2015-16, Open Minds billed MHS \$1,418,868 for services provided. Of that amount, \$1,213,014 had been paid by MHS to Open Minds and \$205,854¹¹ had not been paid as of February 29, 2016.

For purposes of the \$1,213,014 paid to Open Minds, OAAS verified the following:

- \$816,022 was recorded as part of the Fixed Assets (Software) - Construction in Progress account (CIP). MHS had not yet billed cost reimbursement contracts for such services as they relate to an asset that was placed in service in FY 2015-16.¹²
- \$396,392 was recorded as part of MHS’s indirect cost and billed to cost reimbursement contracts, including the County, through indirect rate charges.
- \$600 was recorded as part of the accounts receivable due from Novata and had not been billed to cost reimbursement contracts.

Impact to the County: A portion of the \$396,392 payments made to Open Minds had been billed to County contracts. OAAS is unable to determine the exact amount, as payments to Open Minds were billed indirectly.

Complainant’s Allegation VI:

Lack of Documented Deliverables Provided by Open Minds

Allegation: There has yet to be a single significant documented deliverable provided by Open Minds for the \$1.2M they have received.

¹¹ Unpaid invoices are for services provided from July, 2015 to November, 2015.

¹² Payments recorded as part of the CIP account are allocated to the direct or indirect cost when the asset related to CIP is placed in service. Such allocation is done through depreciation of the asset over its useful life.

Partially Substantiated

MHS provided OAAS three contracts with Open Minds that document deliverables totaling \$145,100. MHS did not provide contracts or documented scope of work for the remaining services provided by Open Minds totaling \$1,273,768. The three contracts provided were for the following services:

- Consulting on the acquisition of CARES (Novata's subsidiary).
- Services of an interim business development director.
- Technical assistance in electronic medical records software selection.

In addition, MHS provided a letter from Open Minds for ongoing consultation. The letter states that Open Minds would provide work preauthorized by MHS at discounted hourly rates. However, the total fee charged for these services is not documented in the letter.

According to MHS's management, Open Minds also provided services based on verbal requests from MHS's management without a formal agreement documenting specific deliverables and compensation. Further, MHS's management stated that it is not efficient to have formal contract agreements for every service provided by Open Minds.

Based on a review of the contracts provided by MHS and invoices paid to Open Minds, OAAS selected a sample of deliverables outlined in these documents. MHS provided a number of documents in support of the services received from Open Minds including memos, meeting agendas, emails, system implementation milestones information, excel templates, etc. However, without a documented scope of work and defined deliverables, MHS was not always able to demonstrate that it received from Open Minds the services it requested and for which it paid.

Impact to the County: Absence of formal contracts that outline service deliverables in support of the full amount paid to Open Minds, results in OAAS's inability to determine whether expenditures related to Open Minds should be included in MHS's indirect cost. As such, indirect rate charged to the County could be affected resulting in overstated indirect expenses allocated to the County.

Complainant's Allegation VII:**Inappropriate Relationship with Open Minds**

Allegation: The owner and several staff members of Open Minds are personal friends of Kim Bond and David Conn, all of whom are known to vacation together...
...It is not known if Ms. Bond or Mr. Conn are receiving kick-backs from Open Minds, but the inappropriateness of this relationship is obvious.

Inconclusive

OAAS interviewed Ms. Bond to inquire about the allegation. She stated that she has no friends or family at Open Minds. She also indicated that she did not vacation with Open Minds staff.

Pursuant to audit provisions in County contracts, County auditors' access is limited to contractor records only. Since the allegation cannot be verified by reviewing MHS records, OAAS was unable to make a determination of its validity.

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|---|
| <u>Impact to the County:</u> Unable to determine. |
|---|

Complainant's Allegation VIII:**Dr. Conn's Role with Open Minds**

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|--|
| <u>Allegation:</u> David Conn, the husband of MHS's President, sits on the advisory board of Open Minds. |
|--|

Substantiated

OAAS's research verified that Dr. Conn is an Advisory Board Member with Open Minds. Further, Ms. Bond confirmed the accuracy of this statement and added that Dr. Conn's position on the Advisory Board is not compensated.

OAAS's review of MHS's Conflict of Interest Disclosure Forms found that Dr. Conn's position with Open Minds was not disclosed to MHS's management. While MHS's Conflict of Interest Policy requires its employees to disclose a financial or employment relationship with a competitor, vendor, or customer/client of MHS, the policy does not require the employees to disclose volunteer positions. According to best business practices, and to provide full transparency, employees should disclose all relationships with competitors, vendors, and customers/clients.

| |
|---|
| <u>Impact to the County:</u> According to County contracts with MHS, MHS shall comply with good business practices. Failure to require all employees to properly disclose all relationships with competitors, vendors, or customer/clients increases the risk that the company will not identify and address conflicts of interest. |
|---|

Complainant's Allegation IX:**Dr. Conn's Appointment**

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|---|
| <u>Allegation:</u> The MHS Board of Directors has approved David Conn's appointment to a highly compensated position, reporting directly to his wife. There is no written job description for this position, and little output that anyone on staff can point to. |
|---|

Unsubstantiated

OAAS confirmed that on November 1, 2015, Dr. Conn was appointed to the Senior Vice President of Business Development & Government Relations position as a result of a restructuring within MHS. According to

MHS's management, the Board of Directors' approval is not needed for the appointment. However, it was noted that the appointment was discussed during a MHS Management Team meeting held on October 19, 2015. Mr. Conn did not receive an increase in compensation as a result of his new position.

Dr. Conn's last salary increase occurred on July 1, 2010; his salary was increased from \$109,116 to \$120,000. The Board of Directors last reviewed and approved Dr. Conn's compensation on October 17, 2011.

Based on OAAS's review of documents provided, Dr. Conn does not report directly to his wife, Kimberly Bond. Specifically, OAAS verified the following:

- From November 1, 2015 to December 1, 2015, David Conn reported to Novata's Chief Operating Officer.
- From December 1, 2015 to February 10, 2016, he reported to MHS's Chief Financial Officer.¹³
- Beginning February 11, 2016, he reports to MHS's Chief Medical Officer.

OAAS reviewed the job description for David Conn's current position and found that it outlines his essential duties and responsibilities at MHS. Based on the documents reviewed, it appears that MHS complied with its internal company policy regarding employment of relatives and chain of command reporting.

Impact to the County: No impact to the County.

Finding I:

As a result of the investigative work conducted by OAAS, the following findings were identified:

Relationship Between MHS and Novata

OAAS identified the following issues that evidenced a lack of an arm's length relationship between MHS and Novata:

- MHS entered into a Support and Guaranty Agreement that required MHS to transfer funds to Novata without interest accrual.
- MHS does not have written agreements for the funds transferred to Novata. According to MHS management, there is an expectation that the transfers to Novata will be recovered and are recognized in MHS records as receivables.

Further, OAAS found that MHS lacks adequate internal controls to demonstrate that transfers to Novata are properly reviewed and approved.

¹³ According to the complainant, the reporting relationship between Dr. Conn and the Chief Financial Officer was administrative only.

Transactions between non-profit MHS and for-profit Novata not undertaken at an arm's length basis could jeopardize MHS's tax exempt status.

Impact to the County: Absence of a formal agreement documenting loans made by MHS to Novata could make it difficult for MHS to recover loan funds from Novata. An inability for MHS to collect loan proceeds could worsen MHS's financial condition and increase the risk that MHS's vendors and subcontractors would not be paid in accordance with County contract terms.

Finding II:

Transactions with Interested Persons

The IRS requires tax exempt organizations to report business transactions with a family member of a current or former officer, director, trustee, or key employee.

According to IRS Form 990, Instructions for Schedule L, an organization must report business transactions with an interested person if compensation payments during the tax year by the organization to a family member of a current or former officer, director, trustee, or key employee of the organization exceeded \$10,000. "Interested person" is defined as a family member of a current or former officer, director, trustee, or key employee.

Kimberly Bond is a current MHS officer. MHS's compensation to her husband, Dr. Conn, is not reported on Schedule L, Part IV. As a result, MHS may not be in compliance with IRS regulations.

Impact to the County: According to MHS's contract with the County, MHS is required to comply with all applicable federal, State, County, and local laws, rules, and regulations, current and hereinafter enacted. By not reporting business transactions with interested persons, MHS may be out of compliance with provisions of County contracts.

Finding III:

Interlocking Directorates

ACS reviewed a sample of direct expenditures claimed by MHS during FY 2014-15 and 2015-16. ACS identified two direct expenditures of \$80 that were questionable. Based on supporting documentation, ACS determined that these expenditures were direct expenditures related to information technology services provided by Novata. The first expense of \$80 was an allocation of a \$6,400 invoice. The second expense of \$80 was an allocation of a different \$2,640 invoice.

MHS failed to notify the County of the use of its for-profit subsidiary, Novata, as a provider of information technology services.

Impact to the County: According to Board of Supervisors Policy A-79 - Interlocking Directorates - the County will not enter into service-type contracts with non-profit corporations who intend to subcontract with related for-profit subcontractors unless specifically authorized by the Board of Supervisors.

MHS's failure to disclose to the County the use of a for-profit corporation appears to be a technical violation of Board Policy A-79. The financial impact is immaterial.

Finding IV:

Management Fees Charged to Novata

Indirect costs incurred by MHS include compensation of MHS staff that provides management, administrative and accounting services to Novata. According to MHS management, in order to offset costs of services provided to Novata, MHS's indirect costs are reduced by the management fees charged to Novata.

MHS did not provide the methodology used to determine the 10% management fee charged by MHS to Novata. As a result, OAAS was not able to validate whether the 10% management fee is an adequate offset from indirect costs.

As required by its contracts with the County, MHS must make available to County, State or federal officials for examination all records relating to the contracts at any time during normal business hours and as often as the County may deem necessary.

Further, OAAS reviewed the calculation for MHS's 15.2% proposed federal indirect rate for FY 2015-16 and noted that the management fees charged to Novata were not deducted from MHS's indirect costs.¹⁴ OAAS recalculated the federal indirect rate by subtracting Novata's management fees from MHS's indirect costs and found the proposed federal indirect rate to be 14.6% which is still slightly higher than the rate charged to the County.

Impact to the County: Indirect rate charged to the County may be affected resulting in overstated indirect expenses allocated to the County.

¹⁴ The proposed Federal indirect rate calculation is used to support indirect rate charged to the County. The indirect rate charged to the County is lower than the proposed Federal indirect rate.

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