STATE OF NORTH CAROLINA

DEPARTMENT OF HEALTH AND HUMAN SERVICES
DIVISION OF SERVICES FOR THE BLIND
BUSINESS ENTERPRISES PROGRAM

FISCAL CONTROL AUDIT

OFFICE OF THE STATE AUDITOR

BETH A. WOOD, CPA

STATE AUDITOR

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AUDITOR'S TRANSMITTAL

November 8, 2011

The Honorable Beverly Eaves Perdue, Governor
The General Assembly of North Carolina
Lanier M. Cansler, Secretary, Department of Health and Human Services
Eddie Weaver, Director, Division of Services for the Blind

This report presents the results of our fiscal control audit at the North Carolina Department of Health and Human Services - Division of Services for the Blind for the Business Enterprises Program. Our work was performed by authority of Article 5A of Chapter 147 of the *North Carolina General Statutes* and was conducted in accordance with the performance audit standards contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. The objective of a fiscal control audit is to identify improvements needed in internal control over selected fiscal matters, such as financial accounting and reporting; compliance with finance-related laws, regulations, and provisions of contracts or grant agreements; and/or management of financial resources.

The results of our audit disclosed deficiencies in internal control and/or instances of noncompliance or other matters that are considered reportable under *Government Auditing Standards*. These items are described in the Audit Findings and Responses section of this report.

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OBJECTIVES, SCOPE, METHODOLOGY, AND RESULTS

OBJECTIVES, SCOPE, AND METHODOLOGY

As authorized by Article 5A of Chapter 147 of the *North Carolina General Statutes*, we have conducted a fiscal control audit at the North Carolina Department of Health and Human Services - Division of Services for the Blind for the Business Enterprises Program. The audit was performed as a result of a complaint filed with the Office of the State Auditor. The complaint expressed concerns related to the operations of the Business Enterprises Program and its compliance with appropriate state and federal guidelines.

The objective of a fiscal control audit is to identify improvements needed in internal control over selected fiscal matters, such as financial accounting and reporting; compliance with finance-related laws, regulations, and provisions of contracts or grant agreements; and/or management of financial resources. Our audit does not provide a basis for rendering an opinion on internal control, and consequently, we have not issued such an opinion.

Management is responsible for establishing and maintaining effective internal control. Internal control is a process designed to provide reasonable assurance that relevant objectives are achieved. Because of inherent limitations in internal control, errors or fraud may nevertheless occur and not be detected. Also, projections of any evaluation of internal control to future periods are subject to the risk that conditions may change or compliance with policies and procedures may deteriorate.

To accomplish our audit objectives, we gained an understanding of internal control over matters described below and evaluated the design of the internal control. We then performed further audit procedures consisting of tests of control effectiveness and/or substantive procedures that may reveal significant deficiencies in internal control. Specifically, we performed procedures such as interviewing personnel, observing operations, reviewing policies, analyzing accounting records, and examining documentation supporting recorded transactions and balances. Whenever sampling was used, we applied a nonstatistical approach but chose sample sizes comparable to those that would have been determined statistically. As a result, we were able to project our results to the population but not quantify the sampling risk.

As a basis for evaluating internal control, we applied the internal control guidance contained in *Internal Control Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). As discussed in the framework, internal control consists of five interrelated components, which are (1) control environment, (2) risk assessment, (3) control activities, (4) information and communication, and (5) monitoring.

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

Our audit was conducted on the Business Enterprises Program within the North Carolina Department of Health and Human Services - Division of the Services for the Blind. The North Carolina Department of Health and Human Services has been given statutory responsibility under *North Carolina General Statutes Chapter 111* for the operation of all programs associated with the blind and visually impaired citizens of the State. The Division of the Services for the Blind administers that responsibility.

<u>Division of the Services for the Blind</u>

The Division of Services for the Blind (Division) provides services to all legally blind and visually impaired residents of the State. The Division's programs are designed to promote employment and independence by the clients served. Services offered by the Division include vocational rehabilitation employment services, independent living services, and the Business Enterprises Program. The Business Enterprises Program is designed to identify and train blind or visually impaired individuals in the operations of vending facilities located primarily on state and federal properties. The Division is responsible for the administration, guidance, and overall direction of the Business Enterprises Program.

<u>Business Enterprise Program</u>

The Business Enterprise Program provides participants who are legally blind with the opportunity to operate their own food service or vending facility. The Business Enterprises Program provides initial training for potential licensees and ongoing counseling and management services to established operators. The length of time required to complete the training depends on the individual's qualification prior to entering the program.

All operators retain the majority of the net proceeds from their facility and a percentage goes back to the Division to assist with program operation and expenses. Business Enterprises facilities are located in federal and state buildings, at rest areas and welcome centers along interstate highways, and in some private locations. On the federal level, the program is known as the Randolph-Sheppard Program.

There are 87 facilities located in North Carolina with gross sales of $7.7 million for the period under audit. Legally blind individuals are trained and licensed by the Division and are competitively awarded facilities where they function largely as independent contractors (operators) and business people. The Division is responsible for locating and establishing feasible facility locations and for providing necessary equipment, initial stock, and petty cash to operate these retail facilities.

Once awarded a facility, the operator is responsible for the day-to-day operations of the facility. The Division continues to provide counseling and management services and monitors the operators to ensure that the facility is managed professionally and that it is as profitable for the operator as it can be. The operator must sign a contract with the Division, which outlines the requirements and standards the operator is expected to meet or exceed.

At February 28, 2011, there were 77 operators. The average net income per operator was $25,407, with the highest net income for an operator at $194,249 and the lowest income at $1,726. The proceeds generated by the facility accrue to the operator minus a small portion, referred to as a set-aside that is remitted to the Division and is similar in nature to a franchise fee. This set-aside assessment is used for offsetting program expenses so that on-going assistance and training may be provided the operator.

In some cases, these facilities are not always profitable. Under the business enterprise policy, operators are guaranteed a fair minimum return, known as the Guaranteed Minimum Return (GMR). The approved GMR rate is $824 per month. Operators whose monthly net income is less than GMR receive a subsidy amount from the Division for the difference between their net profit up to the GMR amount. GMR amounts are funded from set-aside receipts collected within the program.

Controller's Office – Business Enterprise Financial Accounting Unit

The Business Enterprise Financial Accounting (BEFA) unit is responsible for the general accounting functions of the Business Enterprises Program. On a monthly basis, each operator is required to turn in a monthly summary financial report (referred to as a "D-Sheet) to the BEFA Unit. This unit enters the data to the accounting system and generates the monthly statement of revenue and expense report.

In addition, this unit is responsible for receipting, recalculating and tracking the operators' monthly set-aside checks. The set-aside amount is recalculated using data from the monthly summary financial report and compared to the check amount. Late, underpaid, and unpaid set-asides are communicated to the Business Enterprises Program Chief for follow-up with the operator.

Our audit scope covered the period July 2010 through February 2011. During our audit, we considered internal control related to the following accounts and control objectives:

Set-aside Fee – This fee is paid by each operator on a monthly basis. The set-aside is charged at 17% of the operator's net income. At February 28, 2011, the Program reported a total of $422,455 for set-aside fees paid by the operators. We examined internal control designed to ensure the operators calculated the set-aside fee correctly and remitted the set-aside fee timely.

Guaranteed Minimum Return Payment – This is the amount paid to the operator in the event the operator has not generated at least a minimum of $824 per month in net income. The operator is paid an amount up to the $824 guarantee minimum return. At February 28, 2011, the Program reported a total of $31,716. We examined internal control designed to ensure the guaranteed minimum return amount paid to the operator was calculated correctly.

Operator Revenues and Expenses – The revenues include each operator's food and vending sales. The expenses include each operator's allowable business expenses, including wages and benefits, administration services, maintenance agreements, food and beverage purchases. At February 28, 2011, the Program reported total related revenues and expenses of $7,694,484 and $7,309,941, respectively. We examined internal control designed to ensure:

a. the operator sales, receipts, invoices, and supporting records are maintained to verify the accuracy and completeness of the amounts reported

b. the facility sales and gross profit percentage figures are properly calculated and supported.

Division Oversight and Monitoring – Our audit included oversight activities of the Division for the daily operations of the facilities and the performance of the operators. We examined control activities by the Division related to fiscal and programmatic monitoring to ensure operators were in compliance with federal and state guidelines, as well as contract provisions and program policies.

RESULTS

The results of our audit disclosed deficiencies in internal control and/or instances of noncompliance or other matters that are considered reportable under generally accepted government auditing standards. These items are described in the Audit Findings and Responses section of this report.

Management's responses are presented after each of the findings. We did not audit the responses, and accordingly, we express no opinion on them.

AUDIT FINDINGS AND RESPONSES

1. FOOD SERVICE FACILITIES NOT MONITORED TO ENSURE PROGRAM AND OPERATOR COMPLIANCE

The Division has not monitored food service facilities and operators within the Business Enterprise Program in accordance with state guidelines or division policies. The Business Enterprise Program serves to provide employment opportunities to the legally blind citizens of North Carolina through the operation of vending and on-site food service facilities throughout the State. Without proper monitoring, there is an increased risk of noncompliance with federal and state regulations.

<u>Operator Agreements Not on File or Properly Updated</u>

The Business Enterprise Policies and Procedures Manual requires that each operator awarded the opportunity to manage a Business Enterprises facility must sign a contractual agreement between the Division and the operator that outlines the requirements and expectations for performance of both parties. The standard term of the operator agreement is for a period of two years.

Our audit tests included a sample of 44 operators during the period under review. Of those 44 sample operators, we noted:

- Two operator agreements could not be located for review.
- Four operator agreements were missing the appropriate signatures of either the operator or the Division Chief.
- Updated operator agreements were not on file for 27 operators with contract dates ranging from August 1987 through February 2009.

<u>Operator Evaluations or Reviews Not Performed</u>

The Manual for Food Service Facility Operators provides that the Division conduct annual and semi-annual reviews and evaluations of each operator. The purposes of the reviews are to objectively evaluate the operator's compliance with various performance standards, establish operator goals for each year, document a history of the operator's performance, and assist in the awarding of vacancies or in supporting disciplinary actions.

The manual identifies three major evaluations or reviews to be performed. The Operator Agreement Compliance Monitoring Form is to be completed annually and supports operator compliance with the terms of the Operator Agreement. The Operator Evaluation and Goal Setting Evaluation is to be completed annually to document the past year's performance and to set goals for the upcoming year. The Recordkeeping Review is to be performed semi-annually to determine that the operator is in compliance with federal and state program guidelines. Copies of the forms are to be maintained in each operator's file.

We determined that Business Enterprise counselors are not performing the above evaluations and reviews for the program facilities and/or operators. Division personnel indicated that these forms have not been completed "in some time" and that the primary monitoring activity is the Financial Analysis and Operating Standards (FAOS) review.

Financial Analysis and Operating Standards Reviews Not Performed

The Division has established financial management standards as a means for evaluating operating facilities. The purpose of the financial analysis is to determine "what is the absolute best the facility can do given current conditions without consideration for waste, theft, and poor management." The Financial Analysis and Operating Standards (FAOS) reviews give the facility operator a goal or standard to work toward as well as providing a basis for operating standards. The FAOS review is also a part of the transfer and promotion procedures and the monitoring of facility performance. A financial analysis is required to be completed every two years on each facility and updated if conditions in a facility change.

Although there is a requirement that FAOS reviews be performed every two years, we determined that there is not a centralized tracking tool that ensures that these reviews occur as required. We had to inquire of each of the Business Enterprise counselors as to the facilities that they oversaw and when the most recent FAOS reviews had occurred. Based on those inquiries, we identified that, at a minimum, six FAOS reviews had not been performed in accordance with state guidelines:

a. A financial analysis review had not been performed for one facility since September 1995. During the audit period, the sales for this facility totaled $182,519.

b. A financial analysis review had not been performed for one facility since March 2004. Although the operator resigned as of October 2010, he had received $5,651 in guaranteed minimum returns during the period of August 2009 to September 2010. In addition, at the time of resignation, the operator owed the agency $7,302 for petty cash and inventory for which he could not account.

c. A financial analysis review had not been performed for one facility since August 2007. During the audit period, the sales for this facility totaled $92,276.

d. A financial analysis review had not been performed for one facility since the operator started under contract in May 2005. During the audit period, the sales for this facility totaled $449,000.

e. A financial analysis review for one facility was due June 2010, but the Business Enterprises counselor did not perform the review. As of February 2011, no financial analysis review had been performed on this facility.

f. One facility was identified as having a financial analysis review in November 2010; however, documentation of the review could not be produced for the auditors.

According to the North Carolina Administrative Code 63C.0204 Filling of Vacancies (c)(12), a financial analysis shall be done every two years. In addition, Division personnel indicated that the FAOS reviews are the primary monitoring mechanism for the Division.

Recommendation: The Division should strengthen its monitoring of operator activity within the Business Enterprise Program. Specific guidelines and expectations should be added to the Agreement for Operation, as well as the operational manuals. Monitoring activities should be performed in accordance with state and federal guidelines, properly documented, and include follow-up to ensure corrective actions are implemented to address identified program deficiencies.

Agency Response: The Department agrees with the findings and recommendation. The following steps have been implemented or will be implemented once this review is discussed with the Elected Committee of Vendors at their next meeting scheduled for November 19, 2011. Prior to the audit, the Division worked with the Elected Committee of Vendors to update and standardize the policy for operators reporting of allowable net proceeds and a motion passed to accept the new policy at the November 20th, 2011, quarterly meeting of the Elected Committee. At that time, the Business Enterprise counselors were informed of the policy change and advised to resume the previously required record keeping reviews. Effective October 1, 2011, the record keeping reviews will be included in the work plans for the Business Enterprise counselors as one of their required performance measures. Effective October 1, 2011, once per year, the record keeping reviews will be performed on 100% of the operators. In addition, the Division reserves the right to conduct record keeping reviews on any operator as needed.

The Division will begin the process of updating the program manuals to reflect current practices and the Operator Monitoring Form following discussion with the Committee of Elected Vendors at their next quarterly meeting in November 2011. The Division will require evaluation of all operators annually which may be included as a part of the record keeping review to reduce travel for Business Enterprise counselors. The Operator Monitoring Form will certify the operator is in compliance with the guidelines established in the Operator Agreement on an annual basis. The Operator Agreement would remain in effect for the current facility as long as compliance is met. New Operator Agreements would only be required for new operators, or for those operators awarded new facilities. These actions should become effective by March 2012. At this time, the Business Enterprise counselors have been informed to update the Operator Agreements to comply with the current policy requirements to ensure all Operator Agreements are in compliance with current policy until other corrective action has been approved and adopted. The Division considers the previously required Operator Evaluation to be redundant and will remove it from the program manuals.

2. DEFICIENCIES IDENTIFIED IN THE MONITORING RESULTS FOR COMPLETED FINANCIAL REVIEWS

We identified deficiencies in the monitoring results for completed financial analysis reviews for the Business Enterprise Program. As a result, there is an increased risk of noncompliance with state administrative rules and policies. In addition, there is an increased risk that appropriate action will not be taken when facilities fail to meet established minimum financial performance operating standards.

As noted above, the Division has established financial management standards as a means for evaluating operating facilities and providing a basis for operating standards. Our review of the Financial Analysis and Operating Standards (FAOS) reviews performed during the audit period noted that the Division does not effectively monitor the accuracy of the financial information reported by the operators and reviewed by counselors.

We identified a population of 24 completed FAOS reviews applicable to our audit period. We selected a sample of six facilities to test, and noted the following deficiencies:

a. Three facilities reported sales or the gross profit percentages that were not properly calculated.

b. Two facilities had supporting spreadsheets that did not agree with the three-month sales amounts used to calculate the standard gross profit.

c. Five facilities reported purchased units cost and count amounts on FAOS schedules that did not agree to invoice records.

d. For one facility, the Division could not locate the FAOS financial analysis form, schedule, or invoice records. The facility had $315,314 in sales during the audit period. The monthly sales amount ranged from $45,655 for July 2010 to $21,906 for February 2011.

The Manual for Food Service Facility Operators states that “performance against standards is a major part of our process to transfer or promote an Operator” and that monitoring is an important task of the Business Enterprise counselors.

Recommendation: The Division should strengthen its monitoring to ensure that the Business Enterprise Program meets its responsibilities to promote operator success. State administrative rules that require the operators to maintain adequate records to assist the consultants in performing financial analysis reviews should be enforced. In addition, the Division should develop procedures to ensure that the FAOS reviews performed by the Business Enterprise counselors are consistently and accurately completed.

Agency Response: The Department agrees with the finding and recommendation. The Division will work with the Elected Committee of Vendors to revise current policies related to record keeping and Financial Analysis and Operating Standards (FAOS) reviews at the November 2011 quarterly meeting. Discussion will also include the potential development of a centralized position that would maintain the FAOS reviews for all operators and a log of completion dates and other relevant details in order to address the FAOS recommendation. As previously noted, the policy for computing operator net proceeds was implemented effective January 1, 2011, and record keeping reviews are now required. The anticipated date for completion of these corrective actions is March 2012 with the exception of the staff position which will take longer to develop and be approved by the Division/Department and may not be finalized until June of 2012 or later.

In response to the recommendation regrading the Division's responsibility to promote operator success, we would like to note that since October 2010, the Division has successfully opened new facilities at the U.S. Coast Guard Support Center in Elizabeth City, North Carolina, the USPS Processing and Distrubution Center in Raleigh and the Randoph County Visitors Center and Rest Area. Currently, the Division is in negotiations for new facilities with the U.S. Armed Forces Command (FORSCOM) on Fort Bragg and the North Carolina National Guard Joint Force Headquarters in Raleigh. With the addition of new facilities, the Division has also been able to place five newly trained licensees in facilities since April 2011. Additionally, during the last State fiscal year, the average operator income in North Carolina increased by slightly more than 10% up to $43,510. Guaranteed Minimum Return (GMR), the amount paid to support underperforming facilities, has averaged less than $40,000 per year and is down from a high of $72,900 in 2000, which is significant since GMR is supported by 100% of program set-aside receipts.

3. DEFICIENCIES IDENTIFIED IN OPERATORS' REPORTED FINANCIAL DATA

We identified deficiencies in the operator's monthly reports of revenue and expense data for the Business Enterprise Program. As a result, there is an increased risk of the incorrect calculation of the required operator set-aside amounts. Set-aside funds are an assessment against the net proceeds of each vending facility in the Program and can be spent only for such items as equipment, management services, and assuring a fair minimum return to vendors.

Operators are required to send in a Summary Report of Income and Expenses (referred to as a “D-Sheet”) to the Department’s Controller’s Office each month. The D-Sheets report revenues, expenses, net proceeds, and the set-aside expense amount. According to the Business Enterprise Fiscal Operations Procedures Manual, Record Retention for BE Operators policy, each operator should organize and maintain all payments of invoices by month and have the invoices available for audit by the division, staff, and state and federal tax officials.

We examined a sample of 40 monthly operator D-Sheets, including the supporting records provided by the operators. We determined that 33 did not have adequate documentation to support the amounts reported. The following deficiencies were noted:

- Twenty-eight of the operators’ D-Sheets lacked supporting documentation for the revenues and/or expenses reported, including accurate daily sales reports, cashiers tapes for cafeteria sales, payroll, contract labor, workman compensation, medical insurance, rent, telephone, and food and soft drinks purchases. Unsupported revenues and expenses reported by the operators totaled $220,522 and $52,910, respectively.

- Five operators did not provide any documentation to support the amounts reported on their monthly D-Sheets. Total sales and expenses reported for these operators were $40,766 and $33,715, respectively.

The Manual for Food Service Facility Operators states that the operator “will keep such records and make such reports as required to assure the accuracy and completeness of accounting records and other information required by federal or state law.” The current monitoring activities of the Business Enterprises counselors do not provide sufficient assurances that the revenue and expense data reported by the operators are accurate and supported with proper records.

Recommendation: The Division should enhance its procedures for monitoring the accuracy of the financial information reported by the operators, including sufficient reviews of supporting documentation. More specific guidelines that address the calculation of revenues, expenses, net proceeds, and the set-aside expense amount would assist with more accurate reporting of operator sales activities. In addition, documentation requirements should be clearly communicated to ensure that amounts reported are adequately supported.

Agency Response: The Department agrees with the finding and recommendation. Corrective action has been underway since early 2010, and the Division will work with the Elected Committee of Vendors to strengthen program monitoring procedures at the next quarterly meeting scheduled for November 19, 2011. Corrective action should be completed by March 2012.

As previously noted, we do believe this process was improved with the November 2010 implementation of the new policy regarding the calcualtion and reporting of operator net proceeds. Monthly financial printouts are still being provided to the Business Enterprise counselors at this time for review. Effective October 1, 2011, the Division will require monthly reports from each Business Enterprise counselor noting any operator that is not meeting their financial stardards and/or receiving GMR assistance with corrective action plans as needed.

4. REQUIRED OPERATOR SET-ASIDE PAYMENTS NOT REMITTED TIMELY

The Business Enterprise Program does not have processes in place to ensure that operators remit their required set-aside payments in a timely manner. Set-aside funds are an assessment against the net proceeds of each vending facility in the Program. As a result, there is an increased risk that the set-aside funds will not be available for necessary program expenditures or be collected from deficient operators.

Operator set-aside funds are derived from the net proceeds of each facility and are to be used only for specific purposes, including assuring a fair minimum return for the operator of each facility. *North Carolina Administrative Code 63C.0702 Set-Aside (b)* requires the Division to set-aside funds from the net proceeds of each facility to meet federal requirements.

We examined a sample of 60 set-aside payments totaling $25,222. We identified 24 payments totaling $8,419 that were not timely remitted by the operators:

a. Fourteen payments totaling $5,434 were remitted up to one week late.

b. Three payments totaling $877 were remitted between one and two weeks late.

c. Two payments totaling $943 were remitted between two and three weeks late.

d. Four payments totaling $1,114 were remitted between four and ten weeks late.

e. One payment of $51 due for July 2010 was never remitted. The operator retired in October 2010 and never paid the set-aside amount.

The Manual for Food Service Facility Operators requires that operator set-aside payments be remitted by the 15th day of the month following the business month. As of January 1, 2011, the Department Controller's Office has established a spreadsheet to track set-aside amounts due from the operators. Currently, there are no penalties or consequences provided in policy that address an operator's failure to timely submit the required set-aside amounts. It should be noted that a monitoring procedure that is no longer being performed, the Operator Evaluation and Goal Setting Evaluation, required Business Enterprise counselors to review operator timeliness for submission of their set-aside payments.

Recommendation: The Division should enhance its policies and procedures, including the consideration of a penalty for late remission, to ensure that set-aside payments are remitted by the operators by the 15th day of the following month.

Agency Response: The Department agrees with the finding and recommendation. Corrective action has already been proposed as discussed below to reduce this delay in payment, and further action will be discussed at the November 19, 2011 Elected Committee of Vendors meeting.

As reported during the audit, the Division became aware of this concern in 2010 while processing the set-aside rebate. As indicated in the audit findings, the DHHS Controller's Office established a spreadsheet in January 2011 to track all operator program debt as well as set-aside remittance. Since that time, the total amount owed has been significantly decreased to under $14,000 from just over $25,000. Since the development of this spreadsheet, this document is monitored on a monthly basis by the Division to ensure all active operators are paying for past debts. The issue of a penalty for late set-aside remittance has been discussed with the Elected Committee of Vendors for some time and will again be addressed at the November quarterly meeting. The Division does support the penalty as a way to curb late set-aside remittance. It this penalty is adopted by the Elected Committee of Vendors, the expected date for implementation would be March of 2012.

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