

# STATE OF NORTH CAROLINA

OFFICE OF THE STATE AUDITOR

BETH A. WOOD, CPA



## EASTPOINTE HUMAN SERVICES

BEULAVILLE, NC

INVESTIGATIVE REPORT

JUNE 2015



**NC**  **OSA**  
The Taxpayers' Watchdog

# EXECUTIVE SUMMARY

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## **PURPOSE**

The Office of the State Auditor received an allegation through the *State Auditor's Hotline* concerning the credit card use of the former Chief Financial Officer (CFO) at Eastpointe Human Services (Eastpointe). During the course of investigating the initial allegation, the investigation was expanded to include the diversion of funds to the CFO's personal bank account and other matters.

## **BACKGROUND**

Eastpointe, a managed care organization (MCO), is responsible for the management and oversight of the state's public system of mental health, developmental disabilities, and substance abuse services for its service area. Eastpointe is a local political subdivision of the State of North Carolina and receives its funding from federal (Medicaid), state, and local sources.

## **KEY FINDINGS**

- Former CFO facilitated apparent kickbacks totaling \$547,595 from two Eastpointe contractors
- Former CFO purchased three vehicles totaling \$143,041 without a documented business purpose
- Former CFO purchased \$18,600 of equipment for personal use
- Former CFO, Chief Executive Officer (CEO), and other employees used Eastpointe credit cards to make \$157,565 of questionable purchases
- Inadequate CEO and area board oversight contributed to operational failures

## **KEY RECOMMENDATIONS**

- Eastpointe's area board should pursue legal action to recover any misappropriated funds
- Eastpointe's area board should ensure the purchase or lease of vehicles is evaluated for necessity and prudent use of taxpayer funds
- Eastpointe's area board should strengthen procedures to prevent unnecessary equipment purchases
- Eastpointe's area board should establish a comprehensive policy for the assignment and use of credit cards
- Eastpointe's CEO and area board should assess and improve their oversight and procedural compliance to reduce the risk of operational failures

*Key findings and recommendations are not inclusive of all findings and recommendations in the report.*

STATE OF NORTH CAROLINA  
**Office of the State Auditor**



**Beth A. Wood, CPA**  
State Auditor

2 S. Salisbury Street  
20601 Mail Service Center  
Raleigh, NC 27699-0601  
Telephone: (919) 807-7500  
Fax: (919) 807-7647  
<http://www.ncauditor.net>

## AUDITOR'S TRANSMITTAL

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June 2, 2015

The Honorable Pat McCrory, Governor  
Members of the North Carolina General Assembly  
Mr. J. W. Simmons, Chair, Area Board, Eastpointe Human Services  
Dr. Aldona Zofia Wos, Secretary, North Carolina Department of Health and Human Services

Ladies and Gentlemen:

Pursuant to *North Carolina General Statute §147-64.6(c)(16)*, we have completed an investigation of allegations concerning Eastpointe Human Services. The results of our investigation, along with recommendations for corrective action, are contained in this report.

Copies of this report have been provided to the Governor, the Attorney General and other appropriate officials in accordance with *G.S. §147-64.6(c)(12)*.

Respectfully submitted,

A handwritten signature in cursive script that reads "Beth A. Wood".

Beth A. Wood, CPA  
State Auditor

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**Beth A. Wood, CPA**  
State Auditor

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Article V, Chapter 147 of the North Carolina General Statutes, gives the Auditor broad powers to examine all books, records, files, papers, documents, and financial affairs of every state agency and any organization that receives public funding. The Auditor also has the power to summon people to produce records and to answer questions under oath.



# BACKGROUND

The Office of the State Auditor received an allegation through the *State Auditor's Hotline* concerning the credit card use of the former Chief Financial Officer (CFO) at Eastpointe Human Services (Eastpointe). During the course of investigating the initial allegation, the investigation was expanded to include the diversion of funds to the CFO's personal bank account, as well as other matters.

The investigation included the following procedures:

- Interviews with current and former Eastpointe employees, vendors, and others
- Analysis of Eastpointe documents and records
- Analysis of banking records for selected Eastpointe contractors and the former CFO
- Review of applicable Eastpointe personnel files
- Review of applicable sections of the North Carolina General Statutes
- Review of Eastpointe's policies and procedures
- Forensic examination of selected Eastpointe computers

This report presents the results of the investigation. The investigation was conducted pursuant to *North Carolina General Statute § 147-64.6(c)(16)*. **The scope of this investigation did not include payments to mental health service providers.**

### Eastpointe Human Services

Eastpointe is a local governmental entity responsible for managing, coordinating, facilitating and monitoring the provision of mental health, developmental disabilities, and substance abuse services in the area it serves.<sup>1</sup> In addition to Eastpointe, there are eight other managed care organizations (MCOs), formerly called local management entities (LMEs), in North Carolina.

Eastpointe contracts with the North Carolina Department of Health and Human Services (DHHS) to manage the delivery of mental health and other services through a network of licensed practitioners and provider agencies. It is governed by an area board consisting of representatives from each of the 12 boards of county commissioners in their service area and their appointees. Its service area is Bladen, Columbus, Duplin, Edgecombe, Greene, Lenoir, Nash, Robeson, Sampson, Scotland, Wayne and Wilson Counties. Eastpointe serves approximately 180,000 people from its administrative headquarters in Beulaville and other locations in Rocky Mount, Goldsboro, and Lumberton. The agency has approximately 300 employees.

Eastpointe began receiving Medicaid funding when it became an MCO on January 1, 2013. The DHHS Division of Medical Assistance is responsible for monitoring the use of Medicaid funding under its contract with Eastpointe. The majority of Eastpointe's funding prior

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<sup>1</sup> <http://www.ncdhhs.gov/dma/services/lmes.htm>

to 2013 was received from state and local sources. The DHHS Division of Mental Health, Developmental Disabilities, and Substance Abuse Services is responsible for monitoring the use of funding paid under their contract with Eastpointe.

**EASTPOINTE FUNDING SOURCES\***

<b>Source</b>	<b>2012</b>		<b>2013</b>	
	<b>Amount</b>	<b>%</b>	<b>Amount</b>	<b>%</b>
County	\$ 5,104,272	21.7%	\$ 3,091,707	1.7%
State	16,771,694	71.4%	42,890,408	23.9%
Medicaid	-	0.0%	130,509,408	72.7%
Other Federal	1,621,677	6.9%	3,016,841	1.7%
<b>Total Funding</b>	<b>\$ 23,497,913</b>	<b>100.0%</b>	<b>\$ 179,508,365</b>	<b>100.0%</b>

\* Per Eastpointe audited financial statements for fiscal years 2012 and 2013.



# **FINDINGS AND RECOMMENDATIONS**



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## 1. FORMER CFO FACILITATED APPARENT KICKBACKS TOTALING \$547,595 FROM TWO EASTPOINTE CONTRACTORS

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The former Chief Financial Officer's (CFO) unilateral hiring of two contractors, approval of their invoices and payments, together with the subsequent payments from the two contractors to the former CFO was consistent with a kickback scheme.<sup>2</sup> The former CFO may have violated several state laws including fraud, misrepresentation, and obtaining property by false pretenses.<sup>3</sup>

As a result, the funding available to North Carolina residents in need of mental health or substance abuse services was reduced by a corresponding dollar amount.

From January 2010 to December 2013, Eastpointe paid two contractors a total of \$1,030,420 for renovations to Eastpointe buildings. The two contractors then paid a total of \$547,595 to the former CFO from the payments they received from Eastpointe.

The first of the two contractors is a full-time serviceman for a LP gas company who does contracting work on the side, primarily evenings and weekends. The majority of this contractor's invoicing to Eastpointe was for labor and materials related to framing, drywall, doors, painting, and laminate flooring.

- Eastpointe paid this contractor a total of \$986,600 between January 2010 and December 2013. The contractor wrote personal checks to the former CFO totaling \$513,300 during the same time frame. The payments followed a pattern: each time a check was received from Eastpointe, the contractor would write a check to the former CFO.
- The contractor submitted invoices to Eastpointe that were not dated and did not contain adequate descriptions of the work performed or materials used.
- The contractor initially told investigators that he had written only one check to the former CFO in the amount of \$38,000. A review of the contractor's banking activity showed that he had actually written 16 personal checks to the former CFO between 2010 and 2013. When confronted with this information, the contractor admitted to making numerous payments to the former CFO.
- The contractor said he made the payments to the former CFO to reimburse him for the cost of materials he used for his jobs at Eastpointe. According to the contractor, the former CFO told him that he had paid for the materials using his personal funds.
- The former CFO does not have any receipts in support of the \$513,300 of material purchases he allegedly made using his own personal funds.

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<sup>2</sup> Kickback schemes involve collusion between employees and vendors. In a common type of kickback scheme, a vendor submits a fraudulent or inflated invoice to the victim organization and an employee of that organization helps make sure that a payment is made on the false invoice. For his assistance, the employee/fraudster receives a payment from the vendor. This payment is the kickback. Association of Certified Fraud Examiners, "Bribery and Corruption," *Fraud Examiners Manual* (Austin, TX: ACFE, 2011), 1.702.

<sup>3</sup> *North Carolina General Statute § 14-234* - Public officers or employees benefiting from public contracts; exceptions; *North Carolina General Statute § 14-100* - Obtaining property by false pretenses.

- The former CFO told investigators he usually purchased materials for the contractor using cash from a safe at his home. The former CFO said he paid with cash because “a lot of the time that’s what people wanted.”

The second of the two contractors is a retired firefighter who was hired to do three jobs for Eastpointe. The majority of this contractor’s invoicing to Eastpointe was for labor and materials related to carpeting and laminate flooring.

- Eastpointe made four payments to this contractor totaling \$43,820. The contractor then wrote personal checks to the former CFO totaling \$34,295.
- The contractor said he made one of the payments to the former CFO to reimburse him for the cost of materials he used for one of his jobs at Eastpointe.
- The contractor said he made another three payments to the former CFO after he was told the jobs were canceled. According to the contractor, the former CFO said the money should be refunded in the form of checks payable to the former CFO. When investigators showed the contractor the invoices that had been submitted to Eastpointe for the canceled jobs, the contractor said they were not his invoices and someone else must have created them.

The Chief Executive Officer (CEO) and the former CFO violated internal control<sup>4</sup> provisions set forth in the Department of State Treasurer’s Policy Manual for Local Governments.<sup>5</sup>

- Eastpointe’s CEO failed to properly monitor Eastpointe’s operations.
- The CEO failed to review documentation supporting disbursements prior to signing checks.
- The CEO’s signature appears on the checks paid to both contractors. However, the CEO could not tell investigators who applied his signature to those checks. Further, the CEO did not know who applied his signature to any checks generated by Eastpointe. Additionally, the CEO was not even sure if his signature had been applied with a stamp or what he called an “electronic” signature. Investigators determined that the checks were all signed using signature stamps. The CEO was unable to tell investigators which Eastpointe employees had possession of the stamps containing his signature.
- The former CFO circumvented internal controls at Eastpointe. The former CFO failed to generate purchase orders and have them independently approved for the work performed by the contractors.

Eastpointe’s policy regarding purchase orders<sup>6</sup> was deficient and would not have prevented the diversion of funds, even if followed. In its current form, the CFO could approve all purchase orders. The CEO has no role in the approval of purchase orders, regardless of dollar amount. In effect, the CFO could authorize any purchase without the CEO’s knowledge.

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<sup>4</sup> Internal control, sometimes referred to as management control, in the broadest sense includes the plan, policies, methods, and procedures adopted by management to meet its missions, goals, and objectives. Government Auditing Standards, 2011

<sup>5</sup> Department of State Treasurer Policy Manual for Local Governments, Section 80: Internal Control, Part I – Objectives and Components of Internal Control; Part III, Section 9 – Internal Control in Cash Disbursements.

<sup>6</sup> Eastpointe Policy B-2.2.9 – Purchase Order Requisition

## RECOMMENDATIONS

- Eastpointe's area board should pursue legal action to recover any misappropriated funds.
- Eastpointe's CEO and area board should assess and improve their oversight and procedural compliance to reduce the risk of operational failures.
- Eastpointe's CEO should establish monitoring tools to identify unusual trends in financial activity associated with direct subordinates.
- As a check signer, the CEO should thoroughly review documentation supporting disbursements prior to signing checks.
- Eastpointe's CEO should control access to his signature stamp.
- Eastpointe's purchasing policy should be revised to include the approval of the CEO for purchases greater than \$500.

**Note: This finding referred to the North Carolina State Bureau of Investigation to determine if there is sufficient evidence to pursue criminal charges related to misappropriation of public funds.**

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## 2. FORMER CFO OMITTED \$547,595 FROM PERSONAL TAX RETURNS

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The former CFO failed to report \$547,595 received from two Eastpointe contractors on his personal tax returns (See Finding 1). Investigators subpoenaed copies of the former CFO's personal income tax returns for years 2010, 2011, 2012, and 2013. A review of these tax returns indicated none of the income received from the contractors was reported.

The significant underreporting of income resulted in a substantial understatement of the former CFO's individual tax liability, and an unfair burden to other taxpayers.

According to IRS Publication 525, the \$547,595 in payments from contractors should have been included in the former CFO's federal and state income tax returns. According to IRS Code section 61, gross income means *all* (emphasis added) income from whatever source derived.

### RECOMMENDATION

- Eastpointe's area board should cooperate with the Internal Revenue Service and the State of North Carolina to ensure that the former CFO amends his personal income tax returns to include \$547,595 of payments from contractors.

**Note: This finding referred to the Internal Revenue Service and the North Carolina Department of Revenue to determine if there is sufficient evidence to pursue criminal charges related to the omission of contractor payments from gross income; and for the assessment and collection of any additional taxes, penalties, and interest.**

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### 3. FORMER CFO PURCHASED THREE VEHICLES TOTALING \$143,041 WITHOUT A DOCUMENTED BUSINESS PURPOSE

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The former CFO used State funds for the purchase of vehicles that appeared both unreasonable and unnecessary.

- On September 20, 2011, the former CFO purchased a 2012 Ford F250 (F250) from a local car dealer at a cost of \$42,784. The F250 was purchased for and used by the Facilities Maintenance Manager, who said that he commuted in the F250 and took it home on nights and weekends. In November 2011, the F250 was upgraded with \$7,800 worth of accessories, including a \$5,095 front bumper and winch combination, \$899 rearview mirror with back-up camera, \$395 toolbox, plus labor, shipping, and tax of \$1,411. In January 2013, a set of 20 inch chrome rims were added to the F250 for \$1,369. After upgrades, the total cost of the F250 amounted to \$51,953. The F250 is still owned by Eastpointe and driven by the Facilities Maintenance Manager.
- On October 12, 2011, the former CFO purchased a 2011 Chevrolet Silverado 2500HD (Silverado) from the same dealer at a cost of \$51,601. The former CFO said that he drove the Silverado home on nights but not on weekends. The CEO said the former CFO needed the truck to make bank deposits. In March 2014, the 2011 Silverado was sold for \$41,800.
- On October 12, 2011, the former CFO purchased a 2012 Buick Enclave (Enclave) from the same dealer at a cost of \$40,856. The Enclave was purchased for and used by the CEO. The CEO said he drove the 2012 Enclave for business purposes, but also admitted he drove it home at night and on weekends. The 2008 Enclave he drove prior to receiving the new one became a fleet vehicle for Eastpointe. In March 2014, the 2012 Enclave was sold for \$26,100. The CEO then resumed driving the 2008 Enclave previously purchased and assigned to him.

Investigators contacted the eight other Managed Care Organizations (MCOs) in North Carolina and determined none of their CEOs or CFOs were assigned a vehicle. Instead, the CEOs and CFOs used their personal vehicles and requested travel reimbursements.

There was no evidence that Eastpointe management evaluated the need for the vehicles, what type of vehicle was needed, or whether leasing or buying would have been more cost efficient. The former CFO's decision to purchase these vehicles and accessories was never reviewed or challenged by the CEO. The CEO said he was unaware that the accessories were purchased for the F250. *U.S. Office of Management and Budget (OMB) Circular A-87* applies to state and local governments. To be allowable under A-87, a cost must be necessary and reasonable for proper and efficient performance and administration of Federal awards. A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the cost.

### RECOMMENDATIONS

- Eastpointe's area board should ensure the purchase or lease of vehicles is evaluated for necessity and the prudent use of taxpayer funds.

- Eastpointe's area board should work with the awarding agencies to determine if the \$143,041 in questioned costs should be refunded.

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#### 4. FORMER CFO PURCHASED \$18,600 OF EQUIPMENT FOR PERSONAL USE

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Eastpointe's former CFO purchased a \$15,900 Massey Ferguson 2410 tractor and a \$2,700 Ditch Witch trencher for personal use and stored the equipment at his home. According to the Facilities Maintenance Manager:

- The tractor was kept at the former CFO's home from the time it was purchased in January 2011.
- The trencher was purchased in February 2011 and taken to the former CFO's house in 2012. It was returned to Eastpointe in September 2014.
- Aside from lending the tractor to two different Eastpointe contractors, neither piece of equipment was ever used for any work at Eastpointe.

The purchase of these assets was unnecessary and lacked documentation to support a business purpose. Additionally, the assets were unavailable for Eastpointe's use. Funds which could have been used for mental health and substance abuse services were instead spent on equipment that had no business purpose.

Eastpointe's policy regarding purchase orders is deficient and would not have prevented the purchase of unnecessary equipment, even if followed. In its current form, the CFO could approve all purchase orders. The CEO has no role in the approval of purchase orders, regardless of dollar amount. In effect, the CFO could authorize any purchase without the CEO's knowledge.

The former CFO disregarded Eastpointe's Asset Management policy<sup>7</sup> which enabled him to keep the assets at his home for several years without detection by Eastpointe management.

The lack of safeguards over assets is a direct violation of Eastpointe's policies and the North Carolina Department of State Treasurer's Policy Manual for Local Governments.

- Inspection of the tractor and trencher revealed that the assets were not tagged. Eastpointe's Director of Financial Operations said that computers and other large information technology purchases are tagged, but not other fixed assets.
- The Director of Financial Operations also said, to her knowledge, a physical inventory of fixed assets has never been performed.

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<sup>7</sup> Eastpointe Policy B-2.2.22: Asset Management

## RECOMMENDATIONS

- Eastpointe's area board should strengthen procedures to prevent unnecessary equipment purchases.
- Eastpointe management should tag fixed assets with a control number that is affixed in a permanent manner.
- Eastpointe management should perform an annual physical inventory of its fixed assets.

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### 5. FORMER CFO CIRCUMVENTED BIDDING REQUIREMENTS WHICH MAY HAVE RESULTED IN EXCESSIVE RENOVATION AND VEHICLE COSTS

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The former CFO violated state laws pertaining to purchase and bidding requirements. Additionally, the former CFO and the CEO violated internal control provisions set forth in the Department of State Treasurer's Policy Manual for Local Governments.<sup>8</sup>

As a result, Eastpointe may not have contracted with the most qualified contractors, received the best price for the renovation project, and was exposed to risks associated with the lack of performance and payment bonds. Two of the contractors who performed renovations participated in the apparent kickback scheme described in Finding 1.

In addition, Eastpointe may not have received the best price for vehicle purchases.

#### Renovations

- The former CFO worked directly with the contractors and personally selected them to perform the renovation work on Eastpointe's facilities. According to the current CFO, the cost of the renovation work totaled \$2,830,924.
- The former CFO bypassed Eastpointe's internal bidding policies and State bidding requirements.
- No evidence existed at Eastpointe to demonstrate any of the renovation work was competitively bid. The renovation project was divided into sections or "rooms," allowing the agency to circumvent the bidding process.
- Eastpointe's CEO was fully aware of the renovation work, yet failed to verify that bids had been obtained.
- The circumvention of the bid process was also made possible by the failure of Eastpointe's area board to properly monitor Eastpointe's operations.

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<sup>8</sup> Department of State Treasurer Policy Manual for Local Governments, Section 80: Internal Control, Part I – Objectives and Components of Internal Control; Part III, Section 9 – Internal Control in Cash Disbursements.

Selection of contractors for the renovation work should have followed Eastpointe's policy and North Carolina General Statutes which require a competitive bid process:

- *North Carolina General Statute § 143-129* states any construction or repair work estimated to cost more than \$500,000 or purchase of apparatus, supplies, materials, or equipment estimated to cost more than \$90,000 are subject to formal bidding requirements.
- Even more restrictive, Eastpointe's policy B-2.2.2 Bidding further states that any construction or repair contract with an estimated cost of \$300,000 or more requires formal bidding.

Renovations were performed at Eastpointe's facilities in Beulaville and Kenansville. The Beulaville location is a former school building that serves as Eastpointe's administrative headquarters. The Kenansville facility is leased to mental health service providers. Between 2009 and 2013, renovation work was performed on the buildings which included the removal of walls and construction of offices, conference rooms, and other workspaces. Much of the renovation work was performed by electricians, plumbers, HVAC technicians, and general contractors.

### **Vehicles**

None of the following purchases were solicited for competitive bid in accordance with the bid requirements of the State and Eastpointe's internal policy.

- On October 12, 2011, the former CFO purchased a 2011 Chevrolet Silverado 2500HD from a local car dealer at a cost of \$51,601.
- On the same date, the former CFO also purchased a 2012 Buick Enclave from the same dealer at a cost of \$40,856.
- On September 20, 2011, the former CFO also purchased a 2012 Ford F250 from the same dealer at a cost of \$42,784.

Eastpointe's CEO was fully aware of the vehicle purchases, yet failed to verify that bids had been obtained.

Eastpointe's purchase of the vehicles should have followed Eastpointe policy and North Carolina General Statutes which require a competitive bid process. Eastpointe policy and *North Carolina General Statute § 143-131* states any construction or repair work or purchase of apparatus, supplies, materials, or equipment estimated to cost more than \$30,000 is subject to informal bidding requirements.

### **RECOMMENDATIONS**

- The finance committee of Eastpointe's area board should monitor all building and construction projects as required by its by-laws to ensure bidding requirements are met.
- Eastpointe management should follow its bidding policy as well as North Carolina state law pertaining to local government contracts to ensure it obtains the best possible price when procuring goods and services.

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## 6. FORMER CFO HIRED AN UNLICENSED AND UNINSURED CONTRACTOR RISKING INFERIOR RENOVATIONS

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Eastpointe paid an unlicensed and uninsured contractor \$986,600 for renovations at Eastpointe from July 1, 2009, to June 30, 2013. This contractor was one of two contractors who participated in the kickback scheme described in Finding 1. The former CFO worked directly with this contractor and personally selected him to perform the renovation work on Eastpointe's facilities, as described in Finding 5.

As a result of hiring an unlicensed contractor, renovations performed by the contractor may have been inferior or unsafe. Further, Eastpointe may have been subject to liability for any injuries to the contractor, contractor's employees, or Eastpointe's employees arising from work performed by the contractor.

Eastpointe management failed to ask the contractor to produce a license or verify the licensing status of the contractor online. Eastpointe management did not obtain proof of insurance and it was later determined that the contractor was uninsured.

The contractor submitted building permit applications for amounts less than \$30,000 circumventing the general contractor licensure requirement. Any permit application more than \$30,000 would have required a North Carolina general contractor license number. The vast majority of the work was performed at the administrative headquarters and was divided into sections or "rooms."

The contractor may have violated *North Carolina General Statute § 87-1* and may be subject to the penalties of *North Carolina General Statute § 87-13*.

- *North Carolina General Statute § 87-1* states, "...any person or firm or corporation who for a fixed price, commission, fee, or wage, undertakes...the construction of any building, highway, public utilities, grading or any improvement or structure where the cost of the undertaking is thirty thousand dollars (\$30,000) or more... shall be deemed to be a 'general contractor' engaged in the business of general contracting in the State of North Carolina."
- *North Carolina General Statute § 87-13* states, "Any person, firm, or corporation not being duly authorized who shall contract for or bid upon the construction of any of the projects or works enumerated in *General Statute 87-1*, without having first complied with the provisions hereof,... shall be deemed guilty of a Class 2 misdemeanor."

### RECOMMENDATIONS

- Eastpointe management should ensure that contractors are licensed through the North Carolina Licensing Board for General Contractors and also request proof of insurance from contractors before awarding contracts.

**Note: This finding referred to the North Carolina Licensing Board for General Contractors.**



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## 7. IRS FORMS WERE UNDERSTATED BY \$738,066 RESULTING IN A REDUCED TAX LIABILITY FOR FIVE CONTRACTORS

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The dollar amounts shown on IRS Form 1099 - *Miscellaneous Income* for five contractors were less than the payments actually made to the contractors according to Eastpointe's accounting records. Two of these contractors participated in the kickback scheme described in Finding 1.

Underreporting or understating payments to contractors creates the potential for contractors to understate taxable income on their federal and state income tax returns.

The former CFO and former Accounting Manager each had a motive to change the 1099s.

The former CFO had a motive to change the 1099s for two of the contractors because the contractors would not want to pay taxes on payments received from Eastpointe but diverted to the former CFO. (See Finding 1) Investigators asked the former CFO why he reduced one contractor's 1099s by \$674,874 over a period of four years, and he denied making any changes to the 1099s. However, the former Accounting Manager said the former CFO asked her how to change the 1099 amount for this contractor, and perhaps one other contractor. The other contractor's 1099 for the year 2011 was understated by \$25,500.

The former Accounting Manager said the former CFO informed her that materials should not be reported on 1099s. However, the former Accounting Manager had a motive to change the 1099s for three contractors because these contractors were related to her.

- One of the contractors was a pest control company owned by her father-in-law that provided services to Eastpointe. In 2011, the 1099 for this company was understated by \$1,950.
- Another contractor was the former Accounting Manager's ex-husband who installed ceiling tile at Eastpointe. His 1099 was understated by \$15,225 in 2011.
- Another contractor was the former Accounting Manager's current husband who performed maintenance jobs including lawn maintenance, cleaning, and power washing. His 1099 was understated by \$14,267 in 2010 and \$6,250 in 2011. The former Accounting Manager said she went into the system and changed the amount of the 1099 for her husband to understate the amount of income. The former Accounting Manager admitted that it was "wrong" to change the 1099 for her husband.

The incorrect reporting of the 1099 amounts was due to an override of internal controls at Eastpointe. The former CFO and the former Accounting Manager had system access to make these changes in Eastpointe's accounting system.

Eastpointe's incorrect reporting of payments to vendors violated federal and state tax regulations.<sup>9</sup>

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<sup>9</sup> 26 U.S. Code § 6041 - Information at source

**RECOMMENDATIONS**

- Eastpointe management should issue corrected 1099s to contractors to reflect actual payments to contractors for the years affected.
- Eastpointe’s area board and CEO should assess the adequacy of policies associated with year-end tax reporting.

**Note: This finding referred to the Internal Revenue Service and the North Carolina Department of Revenue to determine if there is sufficient evidence to pursue criminal charges related to the understatement of payments on 1099s; and for the assessment and collection of any additional taxes, penalties, and interest that may be due.**

**8. FORMER CFO, CEO, AND OTHER EMPLOYEES USED EASTPOINTE CREDIT CARDS TO MAKE \$157,565 OF QUESTIONABLE PURCHASES**

From July 1, 2009, to June 30, 2013, the CEO, former CFO, and other Eastpointe employees made questionable purchases of \$157,565 using Eastpointe credit cards. A significant portion (75%) of the questionable purchases were made by the former CFO. Most of the questionable purchases were not supported by an explanation of business purpose.

The funds used for questionable credit card purchases could have instead been used to support the delivery of mental health services to Eastpointe’s constituents.

**Questionable Credit Card Expenditures**

<b>Former CFO Questionable Purchases</b>			
	<b>No Receipt</b>	<b>Receipt*</b>	<b>Total</b>
Visa	\$ 90,899	\$ 4,562	\$ 95,461
American Express	16,764	3,583	20,347
Lowes	-	1,741	1,741
<b>Total</b>	<b>\$ 107,663</b>	<b>\$ 9,886</b>	<b>\$117,549</b>

<b>CEO Questionable Purchases</b>			
	<b>No Receipt</b>	<b>Receipt*</b>	<b>Total</b>
Visa	\$ 4,875	\$ 14,447	\$ 19,322

<b>Various Employees Questionable Purchases</b>			
	<b>No Receipt</b>	<b>Receipt*</b>	<b>Total</b>
Walmart	\$ 3,004	\$ 17,690	\$ 20,694

<b>Total Questionable Purchases</b>			
	<b>No Receipt</b>	<b>Receipt*</b>	<b>Total</b>
<b>All Cards</b>	<b>\$ 115,542</b>	<b>\$ 42,023</b>	<b>\$157,565</b>

\* Expenses with receipts were considered questionable if the purchase did not have a documented business purpose

The former CFO charged questionable items to credit cards such as:

- A \$4,500 down payment for repair work on his personal fishing boat, fish finder software for \$935, and Dick's Sporting Goods purchases for \$933
- Two charges totaling \$2,950 for Walmart gift cards
- \$1,741 in purchases including trash cans, flashlights, a patio door, and various other home improvement items

The CEO said that he believed the Walmart gift cards were used as Christmas gifts for Eastpointe employees at the Christmas party. None of these purchases could be verified as an Eastpointe business expense by the CEO or current CFO.

Various employees used the Walmart credit cards to make questionable purchases such as:

- \$2,850 in gift cards which the CEO again said were for employee Christmas gifts

The CEO made questionable purchases such as:

- \$5,308 for a staff luncheon
- \$1,045 for duffel bags for board member Christmas gifts
- \$575 for pecan brittle and chocolate covered pecans for a board Christmas party
- \$245 of gift cards and gifts for an employee Christmas party

The CEO initially explained the source of money used for the questionable purchases was local funding.<sup>10</sup> The CEO said that local funding did not have any restrictions and could be spent as Eastpointe deemed appropriate. Upon further review of the credit card transactions, investigators determined that these purchases were not made with local funds only, but also included federal and state funds. Federal and state funds *are* subject to various spending guidelines.<sup>11</sup>

The explanations provided by Eastpointe's management were insufficient, not supported by adequate documentation, and still appeared unallowable based on federal and state spending guidelines. For example, the explanation for numerous transactions was "appropriate Eastpointe expenditure."

Eastpointe did not have a policy or procedure in place governing the opening of credit card accounts or specifying usage and approval requirements. The former CFO and the CEO violated internal control provisions set forth in the Department of State Treasurer's Policy Manual for Local Governments.<sup>12</sup>

- The CEO did not approve the former CFO's VISA, American Express, or Lowes credit card purchases.
- The CEO signed the checks paying for the credit cards, but he wasn't sure how his signature was applied to checks.

<sup>10</sup> Local funds are contributed by the counties in Eastpointe's service area.

<sup>11</sup> OMB Circular A-87

<sup>12</sup> Department of State Treasurer Policy Manual for Local Governments, Section 80: Internal Control, Part I – Objectives and Components of Internal Control; Part III, Section 9 – Internal Control in Cash Disbursements.

- The former CFO was able to independently make purchases on the VISA, American Express, and Lowe's credit cards. The CEO did not review or approve any of the credit card purchases made by the former CFO.

### RECOMMENDATIONS

- Eastpointe's area board should establish a comprehensive policy for the assignment and use of credit cards.
- Eastpointe's area board should ensure that its CEO establishes monitoring tools to identify unusual financial activity trends associated with direct subordinates.
- As a check signer, the CEO should thoroughly review documentation supporting disbursements prior to signing checks.

**Note: This finding referred to the North Carolina State Bureau of Investigation to determine if there is sufficient evidence to pursue criminal charges related to misappropriation of public funds.**

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## 9. PERSONAL USE OF EASTPOINTE VEHICLES NOT REPORTED AS TAXABLE FRINGE BENEFIT TO CEO, FORMER CFO, AND FACILITIES MAINTENANCE MANAGER

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The CEO, former CFO, and Facilities Maintenance Manager used their Eastpointe vehicles for commuting and other personal use. Review of applicable federal regulations determined that these employees accrued a taxable fringe benefit for the personal use of their agency vehicles.

- The CEO said that he drove the 2012 Buick Enclave home at night and on weekends.
- The Facilities Maintenance Manager said that he drove the 2012 Ford F250 home at night and on weekends.
- The former CFO said that he drove the 2011 Silverado 2500HD home at night but not on weekends. However, the former CFO was ticketed by Swansboro police on Sunday, January 6, 2013, while pulling his personal boat with the Silverado.

The commuting and other personal use of Eastpointe vehicles was not included in those individuals taxable income as a taxable fringe benefit by Eastpointe as required by Internal Revenue Service (IRS) regulations.<sup>13</sup> IRS Publication 15-B, *Employer's Guide to Taxable Fringe Benefits*, states the derived benefit should have been computed using the federal government's "commuting rule."

Eastpointe had no written policies or procedures that addressed the personal use of agency-owned vehicles. Eastpointe maintained no documentation to show which employee was assigned to each vehicle. Furthermore, mileage logs did not exist increasing the risk of employees using the vehicles commuting and personal use.

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<sup>13</sup> 26 CFR 1.61-21 - Taxation of fringe benefits

## RECOMMENDATIONS

- Eastpointe's area board should evaluate whether commuting or other personal use of Eastpointe vehicles is a prudent use of taxpayer funds.
- Eastpointe's area board should require either the repayment of benefits or the amendment of Internal Revenue Service Wage and Tax Statements to reflect the taxable fringe benefit derived from the private use of publicly-owned vehicles.
- Eastpointe's area board should revise its travel policy to address personal use of Eastpointe vehicles.
- Eastpointe management should ensure that all vehicles have mileage logs, require all staff to track the purpose/use of organization vehicles, and review the logs on a monthly basis.

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## 10. FEDERAL REQUIREMENT TO TAG AND INVENTORY EQUIPMENT NOT PRACTICED

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Eastpointe does not maintain proper inventory records or conduct a physical inventory of equipment purchased using federal funding. While Eastpointe maintains complete records of items purchased:

- Its asset inventory records are incomplete relative to exact location, cost, etc.
- It has never conducted a physical inventory of equipment for comparison to such records.

Eastpointe's lack of required safeguards increases the risk of misappropriation of equipment, loss of equipment, and damage to equipment.

Investigators asked Eastpointe's Director of Financial Operations if assets were tagged when purchased and received and if fixed asset inventories are performed annually. She said that computer and other large information technology purchases were tagged but not other fixed assets. She also said, to her knowledge, no fixed asset inventory had ever been performed.

OMB Circular A-133 requires that equipment records be maintained and a physical inventory of equipment be taken at least once every two years. This inventory is required to be reconciled to the equipment records.

## RECOMMENDATIONS

- Eastpointe management should tag fixed assets with a control number that is affixed in a permanent manner.
- Eastpointe management should perform an annual physical inventory of its fixed assets.

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## 11. INADEQUATE CEO AND BOARD OVERSIGHT CONTRIBUTED TO OPERATIONAL FAILURES

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Eastpointe's CEO and area board failed to provide adequate oversight of operations. The lack of oversight contributed to operational failures, including:

- \$2,830,924 in building renovations that did not follow bidding procedures
- \$143,041 in unnecessary vehicle purchases and upgraded accessories
- \$157,565 in questionable credit card purchases

### CEO Oversight Deficiencies

The CEO failed to adequately oversee the former CFO's activities. For example, the CEO failed to review or approve any of the former CFO's credit card expenditures. The CEO did not authorize or approve the former CFO's vehicle purchases. The CEO did not make appropriate inquiries regarding the extent of building renovations that ultimately exceeded \$2.8 million.

### Area Board Oversight Deficiencies

The area board failed to adequately perform duties as outlined in its by-laws.<sup>14</sup> For example, the board's finance committee failed to adequately monitor building renovations and construction projects to include compliance with bidding requirements.

The area board's inadequate oversight prevented Eastpointe from identifying noncompliance with program requirements and state law. As a result of the operational deficiencies described above, funds were diverted from the intended purpose of providing mental health services to North Carolina residents.

Internal control best practices<sup>15</sup> require a board of directors to provide active oversight:

"The board is responsible for overseeing the system of internal control. With the power to engage or terminate the chief executive officer, the board has a key role in defining expectations about integrity and ethical values, transparency, and accountability for the performance of internal control responsibilities."

## RECOMMENDATIONS

- Eastpointe's CEO and area board should assess and improve their oversight and procedural compliance to reduce the risk of operational failures.
- Eastpointe's area board should seek guidance from an independent expert to assist with the design and implementation of an effective internal control system.

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<sup>14</sup> Eastpointe Area Board By-Laws, Article IX: Committees

<sup>15</sup> Committee of Sponsoring Organizations of the Treadway Commission (COSO)

The North Carolina Department of Health and Human Services (DHHS) and the North Carolina General Assembly should consider evaluating the process for appointing members to the governing boards of Managed Care Organizations (MCOs). MCO governing boards should include individuals with sufficient education and experience to ensure accountability for public funding and minimize operational risks.

There are nine MCOs that manage the provision of mental health, developmental disabilities, and substance abuse services in North Carolina. For the fiscal year ended June 30, 2013, these nine MCOs reported total revenue from federal, state, and local sources of more than \$1.6 billion.

According to officials from DHHS, by July 1, 2016, a consolidation plan will reduce the number of MCOs from nine to four, resulting in a consolidation of public funding for mental health services. The consolidation of funding to fewer MCOs will increase the oversight responsibility for the governing boards of these public entities.

The Office of the State Auditor (OSA) strives to provide the Governor, the General Assembly, and the citizens of North Carolina with complete and accurate information in our reports.

When an agency's response could potentially obscure an issue, mislead a reader, or inappropriately minimize the importance of our findings and recommendations, OSA provides clarifications to the agency's response.

Therefore, OSA offers the following clarifications to the response from Eastpointe Human Services (Eastpointe).

### **OSA Involvement**

Eastpointe's response implies that Eastpointe management voluntarily brought allegations of misappropriation to OSA's attention. Moreover, Eastpointe's response could be misleading because its timeline omits OSA's early involvement in the investigation.

Specifically, the Eastpointe response includes the statement, "Allegations of misappropriation of Eastpointe resources were reported to OSA. Thereafter, Eastpointe representatives met with OSA regarding these allegations in April 2014."

OSA initiated its investigation of Eastpointe in February 2014 after a then-sitting board member confidentially contacted OSA concerning the misappropriation of Eastpointe assets.

### **Board Composition**

Eastpointe's response implies that people who had oversight responsibility when the events described in our report occurred are no longer in those positions.

Specifically, Eastpointe's response states, "...current composition of the Area Board members is substantially different from the composition of the Area Board when the activities giving rise to this finding occurred."

It should be noted that Eastpointe's Chief Executive Officer (CEO), who has day-to-day oversight responsibility, is still serving in the same capacity.

### **Internal Control Issues**

Eastpointe's response suggests that the issues identified in our report resulted from an override of the internal control system instead of an inadequate internal control system.

Specifically, Eastpointe's response states, "...virtually all systems of internal control are subject to management override, and collusion by two or more parties acting together to circumvent the system of control."

However, most of the findings in our report were the result of Eastpointe's internal control deficiencies, not management override of internal controls or collusion.



### CEO Expenditures

Eastpointe's response could mislead a reader because the response states "...the OSA questioned CEO expenditures, upon appropriate review, are legitimate organizational expenses."

The \$19,322 charged by the CEO to his Eastpointe credit card does not meet the federal requirements for allowable expenditures to a federal program. Expenditures totaling \$14,447, which included duffel bags, pecan brittle, chocolate covered pecans and Walmart gift cards for Christmas presents, had receipts but no supporting documentation that identified a business purpose. Credit card charges also included \$5,308 for a staff luncheon at the Clubhouse at River Landing in Wallace (See Finding 8).

Federal guidance included in OMB Circular A-87<sup>16</sup> states costs should be necessary and reasonable for proper and efficient performance and administration of Federal awards and should be adequately documented. Federal guidance does not allow expenditures for meetings or conferences, except when the primary purpose is for the dissemination of technical information. There was no dissemination of technical information at the luncheon.

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<sup>16</sup> OMB Circular A-87 establishes principles and standards for determining costs for Federal awards carried out through grants, cost reimbursement contracts, and other agreements with State and local governments and federally recognized Indian tribal governments (governmental units).



**Corporate Office:**  
 514 East Main Street  
 Post Office Box 369  
 Beulaville, N.C. 28518  
 Administration: 800-513-4002  
 Access to Care: 800-913-6109

Kenneth E. Jones, CEO

May 20, 2015

The Honorable Beth A. Wood, CPA  
 State Auditor  
 Office of the State Auditor  
 2 S. Salisbury Street  
 Raleigh, North Carolina 27699-0601

Dear Ms. Wood:

Eastpointe Human Services ("Eastpointe") sincerely appreciates the opportunity to comment on the Office of State Auditor's ("OSA") draft Investigative Report dated March 2015 and would like to thank you personally for OSA's fine work in this area. Our review of OSA's Investigative Report indicates that the focus of the report substantially involved activities of Eastpointe's former CFO who used his position to override the agency's systems of internal control for personal gain.

As you are aware, Eastpointe's Compliance Department first detected the irregular activities of the former CFO and reported the same to the CEO in early 2013 resulting in the commencement of a management directed internal investigation which resulted in the termination of the former CFO. Thereafter, the Eastpointe Area Board ("Board") authorized the engagement of Cherry Bekaert LLP to perform an in-depth internal forensic investigation. Cherry Bekaert initiated its investigation in January 2014 and concluded in July 2014.

Allegations of misappropriation of Eastpointe resources were reported to OSA. Thereafter, Eastpointe representatives met with OSA regarding these allegations in April 2014. In response to the allegations of misappropriation, OSA initiated an independent investigation separate and apart from Eastpointe's internal forensic investigation.

On May 29, 2014, Eastpointe representatives contacted and met with the District Attorney Ernie Lee to report the preliminary results of the internal forensic investigation. On July 9, 2014, Cherry Bekaert produced its written report ("Eastpointe Report") to Eastpointe's legal counsel. Eastpointe representatives requested another meeting with the District Attorney and a meeting occurred on July 10, 2014, at which time a copy of the Eastpointe Report was presented. On July 22, 2014, at the next regularly scheduled Board meeting, the Eastpointe Report was presented to the Board. Eastpointe representatives also requested a meeting with the SBI Financial Crimes Unit for purposes of reporting its findings contained in the Eastpointe Report. The meeting with the SBI occurred on July 22, 2014. After the meeting

*Managing Behavioral Healthcare for the Citizens of Bladen, Columbus, Duplin, Edgecombe, Greene, Lenoir, Nash, Robeson, Sampson, Scotland, Wayne, and Wilson Counties*

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The Honorable Beth A. Wood, CPA  
Office of State Auditor  
May 20, 2015  
Page 2

with the SBI, the Special Agent in Charge communicated to Eastpointe's representatives in writing on July 24, 2014 that "it is evident that you all have completed a thorough investigation and we look forward to working with you on this." On September 16, 2014, the Eastpointe Report was shared with OSA.

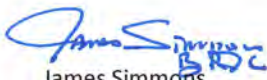
The Board also engaged Cherry Bekaert to perform an internal controls assessment including a comprehensive review and assessment of Eastpointe's anti-fraud program and fraud risks. Cherry Bekaert completed the internal controls assessment in July 2014 and reported the findings to the Board including internal control gaps and recommended remediation strategies. Management has substantially implemented the internal control remediation recommendations or such remediation is in process.

The Board, with limited exceptions set forth in our responses to the OSA findings, accepts the findings and recommendations contained in the Investigative Report. We believe the OSA Report contains substantially similar findings as the Board initiated internal forensic investigation.

As part of our continuing efforts to improve and strengthen our controls, we will give OSA's recommendations careful consideration. The Board strongly believes that Eastpointe has emerged from the Investigation and internal control assessment as a much stronger organization and leader among managed care organizations.

After you have had the opportunity to review our comments and responses to the OSA draft Investigative Report, please contact us with any questions. Again, thank you for your work in this matter and your service to our great state.

Sincerely,

  
James Simmons  
Area Board Chair

JWS/kh

cc: Eastpointe Area Board  
Kenneth E. Jones, Chief Executive Officer  
Sarah Stroud, Chief Financial Officer  
Theresa Edmondson, Chief of Regulations and Compliance  
R. Jonathan Charleston, Esq., Counsel

enclosure

## EASTPOINTE HUMAN SERVICES RESPONSES TO OSA INVESTIGATIVE REPORT SPECIFIC FINDINGS

PRELIMINARY STATEMENT

The Eastpointe Human Services (“Eastpointe”) Area Board of Directors (“Board”) and management team appreciates the diligence and professionalism exemplified by the Office of State Auditor (“OSA”) and the State Bureau of Investigation (“SBI”) during the recent investigation of the matters referred to in the OSA Investigative Report (“OSA Report”) dated March 2015. The Board, with limited exceptions set forth below, accepts the findings and recommendations set forth in the Report. The OSA Report contains substantially similar findings as the Board initiated internal forensic investigation discussed below.

Upon the recommendation of Eastpointe’s CEO, the Board engaged Cherry Bekaert LLP<sup>1</sup> in January 2014 to perform an internal forensic investigation. Cherry Bekaert initiated its investigation in January 2014 and concluded its work in July 2014.

Allegations of misappropriation of Eastpointe resources were reported to OSA. Thereafter, Eastpointe representatives met with OSA regarding these allegations in April 2014. In response to the allegations of misappropriation, OSA initiated an independent investigation separate and apart from Eastpointe’s internal forensic investigation.

On May 29, 2014, Eastpointe representatives contacted and met with the District Attorney Ernie Lee to report the preliminary results of the internal forensic investigation. On July 9, 2014, Cherry Bekaert produced its written report (“Eastpointe Report”) to Eastpointe’s legal counsel. Eastpointe representatives requested another meeting with the District Attorney and a meeting occurred on July 10, 2014, at which time a copy of the Eastpointe Report was presented. On July 22, 2014, at the next regularly scheduled Board meeting, the Eastpointe Report was presented to the Board. Eastpointe representatives also requested a meeting with the SBI Financial Crimes Unit for purposes of reporting its findings contained in the Eastpointe Report. The meeting with the SBI occurred on July 22, 2014. After the meeting with the SBI, the Special Agent in Charge communicated to Eastpointe’s representatives in writing on July 24, 2014 that “it is evident that you all have completed a thorough investigation and we look forward to working with you on this.”<sup>2</sup> On September 16, 2014, the Eastpointe Report was shared with OSA.

In March 2015, OSA produced its Investigative Report to Eastpointe that covered the findings from its independent investigation.

Following the discovery of improper conduct by its former CFO, the Board understood the reputation and political risks associated with having Cherry Bekaert undertake such an in-depth internal forensic investigation of Eastpointe’s financial operations. However, given the circumstances which precipitated the internal forensic investigation and the Board’s fiduciary responsibilities to North Carolina citizens, the Board believed it was necessary and prudent to authorize such an investigation.

<sup>1</sup> Cherry Bekaert LLP is ranked among the largest accounting and consulting firms in United States. The firm’s well-respected Fraud & Forensics Group is comprised of highly experienced professionals with multiple certifications in public accounting (CPA), fraud examinations (CFE), financial forensics (CFF), private investigations (PI), information technology (CITP), and information systems auditing (CISA).

<sup>2</sup> Excerpt of July 24, 2014 email from Michael East, CFE, Special Agent in Charge, Financial Crimes Unit – Special Operations, NC State Bureau of Investigation to R. Jonathan Charleston and Jose A. Coker, counsel to Eastpointe.

Upon the recommendation of Eastpointe's CEO, the Board also engaged Cherry Bekaert to perform an internal controls assessment including a comprehensive review and assessment of Eastpointe's anti-fraud program and fraud risks. In April 2014, Cherry Bekaert reported the findings of its internal control assessment to the Board including internal control and recommended remediation strategies. Eastpointe has substantially implemented the internal control remediation recommendations or such remediation is in process.

Eastpointe has, over time, implemented a series of internal controls to mitigate various risks including the findings identified in the Eastpointe Report and the OSA Report. With respect to these internal controls, it is important to note that "virtually all systems of internal control are subject to management override, and collusion by two or more parties acting together to circumvent the system of control." See COSO, Committee of Sponsoring Organizations of the Treadway Commission, Internal Control – Integrated Framework (2013). In any event, a more robust periodic monitoring and testing of internal controls could have led to earlier detection of the misappropriation. The Board strongly believes Eastpointe has emerged from the internal forensic investigation and internal control assessment as a much stronger organization and leader among managed care organizations ("MCO").

Eastpointe is a local political subdivision of the State of North Carolina and a MCO that serves twelve (12) counties<sup>3</sup> in eastern North Carolina. The agency has responsibility for oversight, coordination, and monitoring of mental health, intellectual developmental disabilities, and substance use addiction services in its catchment area. Eastpointe authorizes payment of medically necessary Medicaid services for residents of the catchment area whose Medicaid originates in the Eastpointe region. Eastpointe also authorizes payment of medically necessary state-funded services for residents without Medicaid or private insurance who live in the Eastpointe catchment area. In addition, Eastpointe manages a \$310 million annual budget, employs approximately 300 employees, contracts with approximately 500 providers and manages a 24/7/365 call center.

Eastpointe began operations in 2001 as Duplin Sampson County Mental Health, one of the smaller mental health programs in the state. Since 2001, Eastpointe has undergone rapid growth through combining with other mental health programs. Since 2006, Eastpointe's CEO and Board have successfully led the organization through many complex changes in the mental health services delivery system mandated by the State of North Carolina. In 2006 Eastpointe evolved from a Mental Health Authority that provided direct care services to a Local Management Entity ("LME") that provided oversight to services within its catchment area. In 2011 Eastpointe was selected by NC Department of Health and Human Services ("NCDHHS") to Manage Utilization of Medicaid for individuals with intellectual and developmental disabilities for the 36 counties comprising the Eastern Region of North Carolina. Eastpointe's Board and management have evolved since September 2012. Today, the Board reflects a substantially new composition as a result of a merger with The Beacon Center<sup>4</sup> and Southeastern Regional Mental Health Center<sup>5</sup> and subsequent legislative mandates.<sup>6</sup>

<sup>3</sup> Bladen, Columbus, Duplin, Edgecombe, Greene, Lenoir, Nash, Robeson, Sampson, Scotland, Wayne, and Wilson counties

<sup>4</sup> Counties served included Edgecombe, Green, Nash and Wilson counties

<sup>5</sup> Counties served included Bladen, Columbus, Robeson and Scotland counties

<sup>6</sup> The matters addressed in the agency's internal forensic investigation and the Report substantially occurred prior to the appointment of a majority of the current Board members.

The people at Eastpointe have worked diligently to achieve better behavioral health outcomes. Eastpointe is a URAC Accredited Health Network, Health Utilization Management, and Health Call Center. Accreditation is an evaluative, rigorous, transparent, and comprehensive process in which a health care organization undergoes an examination of its systems, processes, and performance by an impartial external accrediting body to ensure that it is conducting business in a manner that meets predetermined criteria and is consistent with national standards. URAC is an independent nonprofit organization and well-known leader in promoting healthcare quality through its accreditation, education, and measurement programs. URAC offers a wide range of quality benchmarking programs and services that model the rapid changes in the healthcare system and provide a symbol of excellence for organizations to validate their commitment to quality and accountability. Eastpointe embodies the URAC philosophy of excellence.

On July 1, 2012, Eastpointe completed the combining of functions with the 12 counties in its catchment area through its consolidation with The Beacon Center and Southeastern Regional Mental Health Center. While performing its LME functions, the agency immediately began the six (6) month transition process to become an MCO having been selected to become a MCO through a competitive process<sup>7</sup> implemented by the North Carolina Department of Health and Human Services (“NCDHHS”)<sup>8</sup>. Major changes in Eastpointe’s infrastructure and operations were required to prepare the agency to authorize and pay for behavioral healthcare services within the constraints of a defined financial allocation, in an “at-risk” environment. On January 1, 2013, Eastpointe began management of publicly-funded behavioral healthcare services under the 1915 b/c Medicaid Waiver, having implemented all of the functions of a MCO. On August 1, 2013, the Secretary of NCDHHS issued a certification of compliance, approving Eastpointe to operate the 1915 b/c Medicaid Waiver, a process that occurs every six months. Eastpointe has successfully completed this process since implementation.

In 2014, Eastpointe served 33,306 individuals. Today, Eastpointe’s network includes 28 hospitals, 72 licensed independent practitioners, and 286 provider agencies with a budget of \$310 million.

In March 2013, Eastpointe received an anonymous report alleging agency vehicle misuse by its former Chief of Business Operations (“former CFO”). Shortly thereafter, Eastpointe’s corporate compliance department discovered irregularities relating to the former CFO’s use of an agency-issued credit card. Eastpointe promptly initiated an internal investigation relating to these irregularities. In June 2013, Eastpointe’s CEO terminated the former CFO upon review of its internal investigation and substantiation of misappropriation of agency resources. Eastpointe’s Board was kept informed of the ongoing internal investigation and the CEO’s decision to terminate the former CFO.<sup>9</sup>

The former CFO appealed his termination by filing a Petition for Contested Case Hearing with the Office of Administrative Hearings (“OAH”) alleging wrongful termination.<sup>10</sup> During the pendency of the appeal to OAH, Eastpointe engaged Cherry Bekaert LLP to provide certain consulting services relating to the former CFO’s use of the agency credit card. In January 2014, Eastpointe’s Board authorized

<sup>7</sup> In 2010, Eastpointe successfully responded to an RFP from NCDHHS. Selection criteria included performance, operational readiness, and financial stability.

<sup>8</sup> Effective July 1, 2012, a new Area Board of Directors was appointed to meet the statutory composition requirements. On September 1, 2012, the Area Board composition was modified to comply with the amendments to N.C.G.S. § 122C-118.1.

<sup>9</sup> Area Board Member Albert David Kirby, Jr., Esq., a former assistant District Attorney and practicing attorney, heard the internal appeal of the former CFO and upheld the CEO’s decision of termination.

<sup>10</sup> The former CFO withdrew his Petition for Contested Case Hearing on April 7, 2014.

management to expand the engagement of Cherry Bekaert to conduct an internal forensic investigation relating to unusual and potential irregular activities, potential losses, and internal controls.

Eastpointe's internal forensic investigation, which was completed in July 2014, revealed that two former employees violated Eastpointe's Code of Conduct and acted in collusion to commit fraud. These former employees included the former CFO and former Manager of Accounting Services, both of whom were terminated.<sup>11</sup>

The Eastpointe Report contains separate findings as to five (5) allegations. For the first three (3) allegations, the former CFO is suspected of misappropriating assets through billing schemes in the form of personal purchases and/or purchasing and misusing assets acquired through various Eastpointe corporate credit cards. Cherry Bekaert found multiple irregularities involving use of agency-issued credit cards including mischaracterized credit card charges, weekend purchases, expenses that appeared personal in nature or otherwise questionable as to the business purpose and/or missing supporting documentation and lacking evidence of authorization and application of the Eastpointe CEO signature stamp without evidence of the CEO's review and approval were identified. Cherry Bekaert reported its opinion that the lack of supporting documentation, mischaracterized expenditures noted, numerous weekend purchases, and the lack of evidence of review of the respective credit card charges/receipts by the CEO to be strong indicators of "management override" that circumvent established internal control processes, for which the former CFO was responsible for establishing and maintaining. Cherry Bekaert also reported that under the direction of the former CFO, Eastpointe's policies, procedures, and processes appear to have been circumvented and internal controls applied to other vendor payments were bypassed. These irregularities involved vendor payments relating to general and administrative vendors, not Eastpointe's service providers.

The fourth allegation contained in the Eastpointe Report involves suspected misappropriation of assets through an employee expense reimbursement scheme in the form of overstated and/or fictitious expenses by the former CFO. The allegation resulted in minimal findings and was deemed not in need of further observation.

The fifth allegation contained in the Eastpointe Report involves suspected corruption activities in the form of conflicts of interest and improper reporting of Internal Revenue Service (IRS) Form 1099-MISC income to non-employee vendors involving collusion between the former Manager of Accounting Services and the former CFO. Cherry Bekaert reported that it appears the former CFO, with the aid of the former Manager of Accounting Services, acted together to circumvent and/or override internal controls for personal gain. Cherry Bekaert found these activities represent corruption type activities<sup>12</sup>. Through its investigation, OSA confirmed vendor kickback activity as a result of its interviews of certain vendors and other investigative techniques.

In addition to the foregoing, Cherry Bekaert reported that some purchases of agency equipment appear to have been made for the benefit of the former CFO under the pretext that assets purchased were for Eastpointe including the following:

<sup>11</sup> Eastpointe terminated the former Manager of Accounting Services on May 6, 2014.

<sup>12</sup> Corruption type activities in the form of conflicts of interest are strong indicators of other corruption type activities in the form of: (1) bid rigging (lack of competition bidding for construction and maintenance services); (2) potential invoice kickbacks and/or; (3) purchasing schemes which appear to have resulted in losses to Eastpointe. Cherry Bekaert found the irregular activity as a result of the aforementioned corruption activities amounted to \$773,905. See Eastpointe Report.

- Tractor with front end loader and backhoe
- Trailer with wench to transport above tractor
- 2012 2500 Silverado Truck

Neither Eastpointe nor Cherry Bekaert have thus far found any evidence that any fraud or other irregularities involved payments to providers of mental health, substance abuse or developmental services at the direction of the former CFO.

Notwithstanding, the findings are unfortunate and very disappointing. Eastpointe took immediate action to enhance its internal controls in order to deter fraud and reduce future risk, including, among others:

- Enhancing internal controls for credentialing and authorizing trade vendors
- Enhancing effectiveness of internal controls around use of Eastpointe credit cards
- Elevating awareness of Eastpointe fraud and abuse hotline
- Conducting annual fraud risk awareness training
- Updating Finance Committee charter to provide for greater oversight of hotline activity and management expenses

Eastpointe took swift and immediate action on several issues that surfaced during the course of its internal investigation. To date, Eastpointe has:

- Inventoried and updated the master vendor list
- Updated the vendor authorization process
  - Investigated a new purchasing technology to automate authorization and controls
  - Evaluated the migration of remaining vendor payments to electronic funds transfer (EFT)
  - Reviewed and made changes in staff responsibilities to ensure segregation of duties
- Terminated all auto charges on Eastpointe credit cards
- Increased control and oversight of agency issued credit cards
- Updated the credit card policy to ensure more oversight procedures

Further, the Board acknowledges and agrees that Eastpointe's internal controls are further strengthened as a result of the Board's requirement that the CEO implement an enhanced review of underlying supporting documentation prior to signing checks and enhanced control over the use of signature stamps. However, the Board further acknowledges that it is not always practical for the CEO to review all disbursements given Eastpointe's size, complexity and the scope of the CEO's existing duties. To further strengthen internal control in connection herewith, the Board will determine an appropriate expense threshold through implementation of a more robust purchasing policy.

In addition to the foregoing, Eastpointe has formally requested DHHS to review OSA questioned expenditures previously settled by DHHS. Further, no implication of impact on delivery of mental health, intellectual developmental disabilities, and substance abuse addiction services was detected by



Eastpointe's Investigation and, thus far no evidence of any fraud or other irregularities involving payments to service providers at the direction of the former CFO has been found.

Notwithstanding the foregoing, Eastpointe's external auditors did not disclose any material internal control deficiencies in connection with any audit report submitted to the Board during any relevant time.

The agency takes great pride in being a strong MCO. Eastpointe is committed to continual improvement and operating with honesty and integrity.

## EASTPOINTE HUMAN SERVICES RESPONSES TO OSA INVESTIGATIVE REPORT SPECIFIC FINDINGS

**FINDING NO. 1: FORMER CFO FACILITATED APPARENT KICKBACKS TOTALING \$547,595 FROM TWO FORMER EASTPOINTE CONTRACTORS****OSA RECOMMENDATIONS:**

- Eastpointe’s board of directors should pursue legal action to recover any misappropriated funds.
- Eastpointe’s CEO and board of directors should assess and improve their oversight and procedural compliance to reduce the risk of operational failures.
- Eastpointe’s CEO should establish monitoring tools to identify unusual trends in financial activity associated with direct subordinates
- As a check signer, the CEO should thoroughly review documentation supporting disbursements prior to signing checks.
- Eastpointe’s CEO should control access to his signature stamp.
- Eastpointe’s purchasing policy should be revised to include the approval of the CEO for purchases greater than \$500.

**Eastpointe Response to OSA Finding No. 1:**

See the Preliminary Statement set forth above and incorporated in this response as if fully set forth herein. It should be noted that the current composition of the Area Board (“Board”) is substantially different from the composition of the Board when the activities giving rise to this finding occurred. Notwithstanding, the currently constituted Board authorized the internal forensic investigation and the organizational internal control assessment completed in July 2014 and disclosed to the District Attorney in July 2014, the SBI in July 2014, and OSA in September 2014.

Further, Eastpointe concurs with OSA Finding No. 1. In addition, Eastpointe contends and therefore believes that the former CFO systematically circumvented, overrode and inappropriately used his position to influence other employees and vendors to exploit Eastpointe’s system of internal controls for apparent personal gain. It is important to point out that the Board was alerted to the suspected fraud of the former CFO and the former Manager of Accounting Services within a reasonable time after the information was discovered and investigated by Management. The Board reviewed, discussed in detail, and asked probing questions of Management related to the irregular activities identified in Cherry Bekaert’s report.

Based on the former CFO’s position of influence and direct responsibility to establish and maintain Eastpointe’s financial controls and controls that safeguard agency assets, an expanded investigation was launched utilizing experts in the following 3 areas:

- Fact verification and legal advice in support of a wrongful termination suit filed by the former CFO
- A comprehensive review and gap assessment of our anti-fraud program of controls
- An expanded internal discovery of fraud risk areas based on internal control gaps that appeared to have deteriorated under the former CFO

As previously stated, Eastpointe engaged Cherry Bekaert to assist the agency in strengthening its internal controls. Eastpointe has, over time, implemented a series of internal controls to mitigate various risks including the findings identified in the Eastpointe Report and the OSA Report. With respect to these internal controls, it is important to note that “virtually all systems of internal control are subject to management override, and collusion by two or more parties acting together to circumvent the system of control.” See COSO, Committee of Sponsoring Organizations of the Treadway Commission, Internal Control – Integrated Framework (2013). In any event, a more robust periodic monitoring and testing of internal controls could have led to earlier detection of the misappropriation. The CEO and the Area Board have placed enhanced emphasis on oversight of the following:

- Hotline Reporting
- The Eastpointe Code of Conduct
- Compliance function monitoring activities
- Capital budgets and expenditures (including construction projects and major asset purchases)
- Operational budgets and expenditures (including vehicle leases)
- Executive expense reporting
- Use of Eastpointe credit cards
- Use of Eastpointe vehicles
- Fraud risk awareness training and review of best practices in governance and anti-fraud controls

In addition, the Board is evaluating expanding the role of its Risk Committee to, among other things, considering monthly “red flag”<sup>1</sup> or suspicious activity reports<sup>2</sup>, augmenting the compliance function and establishing an internal audit function. In addition, the Board is considering establishing requirements for senior financial officers (CEO and CFO) to annually reaffirm to a separate code of ethics given the roles of responsibility and influence on the system of internal control.

<sup>1</sup> A “red flag” is a warning sign or a sign that there is a problem that should be noticed or addressed.

<sup>2</sup> For purposes of Eastpointe’s response to the specific findings set forth in the OSA Investigative Report dated March 2015, a suspicious activity report is a report made by Eastpointe about suspicious or potentially suspicious activity. The criteria to decide when a report must be made varies, but generally is any transaction, event or activity that does not make sense to Eastpointe, is unusual, or appears to be done only for the purpose of hiding or obfuscating a transaction, event or activity.

The Board and Management will continue to review governance and anti-fraud programs of controls including Eastpointe's policies and procedures to procure and pay for goods and services. We continue to evaluate and strengthen our monitoring controls with more focus on senior leadership positions, for example:

- Executive expense reporting is regularly reviewed by our Compliance Department and expense amounts incurred by our CEO and CFO are reviewed by the Board Finance Committee quarterly.
- We reinforced our Code of Conduct and fraud reporting requirements through training, requiring annual employee affirmation and by promoting a more robust external hotline mechanism that allows for anonymous reporting.

The Board acknowledges and agrees that the CEO will be required to perform an appropriate review of the underlying supporting documentation before signing a check and maintain appropriate control over the use of signature stamps. However, it is not always practical for the CEO to review all disbursements over \$500 given Eastpointe's size, complexity, and the scope of the CEO's existing duties. The Board will determine an appropriate expense threshold through implementation of a more robust purchasing policy. Therefore, in the process of our comprehensive review of our internal controls over the procurement to payment business cycle, we strengthened the following controls to reduce the risk of misappropriation of assets including:

- Vendor credentialing, authorization and set up
- Segregation of duties and systems access
- Adherence to competitive bidding requirements and authorization limits
- Robust purchase order requirements (including embedding authorization limits for purchases)
- Receipt of goods and services matching controls
- Invoice processing matching controls
- Authorization limits for disbursements
- Electronic payment initiatives in order save time, money and our exposure to check tampering schemes (in process)
- To the degree possible eliminate the need for signature stamps (in process)

This process has strengthened Eastpointe's internal controls to (1) more effectively reduce the agency's exposure to fraud risk, (2) accommodate growth in Eastpointe services, (3) demonstrate sound financial stewardship to the agency's funding agencies, and (4) cost effectively provide mental health service to the counties Eastpointe serves.

Finally, Eastpointe's legal counsel has been directed by the Board to pursue recovery of any funds determined to have been misappropriated. A fidelity bond may also provide coverage for losses caused by the former employees' fraudulent or dishonest actions.

**FINDING NO. 2: FORMER CFO OMITTED \$547,595 FROM PERSONAL TAX RETURNS OSA****RECOMMENDATIONS:**

Eastpointe's board of directors should cooperate with the IRS and State of NC to ensure the former CFO amends his personal income tax returns to include \$547,595 of payments from contractors.

**Eastpointe Response to OSA Finding No. 2:**

See the Preliminary Statement set forth above and incorporated in this response as if fully set forth herein. It should be noted that the current composition of the Board is substantially different from the composition of the Board when the activities giving rise to this finding occurred. Notwithstanding, the currently constituted Board authorized the internal forensic investigation and the organizational internal control assessment completed in July 2014 and disclosed to the District Attorney in July 2014, the SBI in July 2014, and OSA in September 2014.

Eastpointe will cooperate with the Internal Revenue Service ("IRS") and the State of North Carolina with respect to any Federal or state determination, relating to the subject matter hereof, to ensure that the former CFO amends his personal income tax returns to include \$547,595 of payments from contractors. Eastpointe does not otherwise have the legal authority to ensure or require that the former CFO amends his personal tax returns for any purpose.

**FINDING NO. 3: FORMER CFO PURCHASED THREE VEHICLES TOTALING \$143,041 WITHOUT A DOCUMENTED BUSINESS PURPOSE**

**OSA RECOMMENDATIONS:**

- Eastpointe’s board of directors should ensure the purchase or lease of vehicles is evaluated for necessity and the prudent use of taxpayer funds.
- Eastpointe’s board of directors should work with the awarding agencies to determine if \$143,041 in questioned cost should be refunded.

**Eastpointe Response to OSA Finding No. 3:**

See the Preliminary Statement set forth above and incorporated in this response as if fully set forth herein. It should be noted that the current composition of the Board is substantially different from the composition of the Board when the activities giving rise to this finding occurred. Notwithstanding, the currently constituted Board authorized the internal forensic investigation and the organizational internal control assessment completed in July 2014 and disclosed to the District Attorney in July 2014, the SBI in July 2014, and OSA in September 2014.

The Board and Management will continue to review governance and internal controls including Eastpointe’s policies and procedures to procure and pay for goods and services. We continue to evaluate and strengthen our monitoring controls to include development of policies outlining the types of transactions that require Board approval and a system of internal controls that require management to inform the Board of significant transactions. The following controls have been strengthened including adequate oversight of the following:

- Operational budgets and expenditures (including vehicle leases)
- Use of Organization vehicles

In July 2013, Eastpointe issued a request for proposal to replace the agency’s vehicle purchase/ownership program with a fleet leasing and management program. Eastpointe contracted with a fleet leasing and management program in March 2014. The Board determined that it was appropriate to contract with a vehicle leasing company that provides overall management of vehicle use.

Eastpointe will work with the awarding agencies to determine whether it is required to refund any amount identified as questionable by OSA.

**FINDING NO. 4: FORMER CFO PURCHASED \$18,600 OF EQUIPMENT FOR PERSONAL USE OSA****RECOMMENDATIONS:**

- Eastpointe’s board of directors should strengthen procedures to prevent unnecessary equipment purchases.
- Eastpointe’s management should tag fixed assets with a control number that is affixed in a permanent manner.
- Eastpointe management should perform an annual physical inventory of its fixed assets.

**Eastpointe Response to OSA Finding No. 4:**

See the Preliminary Statement set forth above and incorporated in this response as if fully set forth herein. It should be noted that the current composition of the Board is substantially different from the composition of the Board when the activities giving rise to this finding occurred. Notwithstanding, the currently constituted Board authorized the internal forensic investigation and the organizational internal control assessment completed in July 2014 and disclosed to the District Attorney in July 2014, the SBI in July 2014, and OSA in September 2014.

Eastpointe concurs with OSA Finding No. 4. The Board and Management will review governance and internal controls including Eastpointe’s policies and procedures to procure and pay for goods and services. We continue to evaluate and strengthen our monitoring controls to include policies outlining the types of transactions that require Board approval and a system of internal controls that require management to inform the Board of significant transactions. The CEO and the Board will ensure adequate oversight of the following:

- Hotline Reporting
- The Eastpointe Code of Conduct
- Compliance function monitoring activities
- Capital budgets and expenditures (including construction projects and major asset purchases)
- Operational budgets and expenditures (including vehicle leases)
- Use of Eastpointe credit cards
- Use of Eastpointe vehicles
- Fraud risk awareness training and review of best practices in governance and anti-fraud controls

The Board continues to evaluate expanding the role of its Risk Committee to, among other things, considering monthly “red flag” or suspicious activity reports, augmenting the compliance function and establishing an internal audit function. In addition, the Board will consider establishing requirements for senior financial officers (CEO and CFO) to annually reaffirm to a separate code of ethics given the roles of responsibility and influence on the system of internal control. Eastpointe will tag fixed assets in accordance with applicable law to ensure compliance.



**FINDING NO. 5: FORMER CFO CIRCUMVENTED BIDDING REQUIREMENTS WHICH MAY HAVE RESULTED IN EXCESSIVE RENOVATION AND VEHICLE COSTS**

**Recommendations:**

- The finance committee of Eastpointe’s board of directors should monitor all building and construction projects as required by its by-laws to ensure bidding requirements are met.
- Eastpointe’s management should follow its bidding policy as well as NC state law pertaining to local government contracts to ensure it obtains the best possible price when procuring goods and services.

**Eastpointe Response to OSA Finding No. 5:**

See the Preliminary Statement set forth above and incorporated in this response as if fully set forth herein. It should be noted that the current composition of the Board is substantially different from the composition of the Board when the activities giving rise to this finding occurred. Notwithstanding, the currently constituted Board authorized the internal forensic investigation and the organizational internal control assessment completed in July 2014 and disclosed to the District Attorney in July 2014, the SBI in July 2014, and OSA in September 2014.

Based on the results of Eastpointe’s internal forensic investigation and assessment of the agency’s internal controls, we concluded that the former CFO systematically circumvented, overrode and inappropriately used his position to influence other employees and vendors to exploit Eastpointe’s system of internal controls for apparent personal gain.

Eastpointe has, over time, implemented a series of internal controls to mitigate various risks including the findings identified in the Eastpointe Report and the OSA Report. With respect to these internal controls, it is important to note that “virtually all systems of internal control are subject to management override, and collusion by two or more parties acting together to circumvent the system of control.” See COSO, Committee of Sponsoring Organizations of the Treadway Commission, Internal Control – Integrated Framework (2013). In any event, a more robust periodic monitoring and testing of internal controls could have led to earlier detection of the misappropriation. The CEO and the Area Board have placed enhanced emphasis on oversight of the following:

- Hotline Reporting
- The Eastpointe Code of Conduct
- Compliance function monitoring activities
- Capital budgets and expenditures (including construction projects and major asset purchases)
- Operational budgets and expenditures (including vehicle leases)
- Executive expense reporting
- Use of Eastpointe credit cards
- Use of Eastpointe vehicles

- Fraud risk awareness training and review of best practices in governance and anti-fraud controls

It is also important point out that the cost of building renovations during the relevant time period of OSA's investigation, FY 2011-2013 is \$1,391,210. The \$2,830,924 referred to in OSA Finding No. 5 represents the costs of the entire renovation of 2 sites (including renovation of the Beaulaville and Kenansville sites ) from FY 2009 to 2014.

The Board continues to evaluate expanding the role of its Risk Committee to, among other things, considering monthly "red flag" or suspicious activity reports, augmenting the compliance function and establishing an internal audit function. In addition, the Board will consider establishing requirements for senior financial officers (CEO and CFO) to annually reaffirm to a separate code of ethics given the roles of responsibility and influence on the system of internal control.

**FINDING NO. 6: FORMER CFO HIRED AN UNLICENSED AND UNINSURED CONTRACTOR RISKING INFERIOR RENOVATIONS**

**OSA RECOMMENDATION:**

Eastpointe's management should ensure that contractors are licensed through the North Carolina Licensing Board for General Contractors and also request proof of insurance from contractors before awarding contracts.

**Eastpointe Response to OSA Finding No. 6:**

See the Preliminary Statement set forth above and incorporated in this response as if fully set forth herein. It should be noted that the current composition of the Board is substantially different from the composition of the Board when the activities giving rise to this finding occurred. Notwithstanding, the currently constituted Board authorized the internal forensic investigation and the organizational internal control assessment completed in July 2014 and disclosed to the District Attorney in July 2014, the SBI in July 2014, and OSA in September 2014.

Eastpointe concurs with OSA Finding No. 6. The Board and Management will continue to review governance and internal controls including Eastpointe's policies and procedures to procure and pay for goods and services, including compliance with applicable law. We continue to evaluate and strengthen our monitoring controls to include policies outlining the types of transactions that require Board approval, compliance with applicable law, and a system of internal controls that require management to inform the Board of significant transactions. The CEO and the Board will ensure adequate oversight of the following:

- Hotline Reporting
- The Eastpointe Code of Conduct
- Compliance function monitoring activities
- Capital budgets and expenditures (including construction projects and major asset purchases)
- Operational budgets and expenditures (including vehicle leases)
- Use of Eastpointe credit cards
- Use of Eastpointe vehicles
- Fraud risk awareness training and review of best practices in governance and anti-fraud controls

The Board continues to evaluate expanding the role of its Risk Committee to, among other things, considering monthly "red flag" or suspicious activity reports, augmenting the compliance function and establishing an internal audit function. In addition, the Board will consider establishing requirements for senior financial officers (CEO and CFO) to annually reaffirm to a separate code of ethics given the roles of responsibility and influence on the system of internal control.

**FINDING NO. 7: IRS FORMS WERE UNDERSTATED BY \$738,066 RESULTING IN A REDUCED TAX LIABILITY FOR FIVE CONTRACTORS**

**OSA RECOMMENDATIONS:**

- Eastpointe's management should issue corrected 1099s to contractors to reflect actual payments to contractors for the years affected.
- Eastpointe's board of directors and CEO should assess the adequacy of policies associated with year-end tax reporting.

**Eastpointe Response to OSA Finding No. 7:**

See the Preliminary Statement set forth above and incorporated in this response as if fully set forth herein. It should be noted that the current composition of the Board is substantially different from the composition of the Board when the activities giving rise to this finding occurred. Notwithstanding, the currently constituted Board authorized the internal forensic investigation and the organizational internal control assessment completed in July 2014 and disclosed to the District Attorney in July 2014, the SBI in July 2014, and OSA in September 2014.

Eastpointe management is in the process of determining the proper method to file corrected IRS Form 1099 MISC for the contractors affected to reflect actual payments made by Eastpointe.

We have assessed the adequacy of policies and procedures associated with year-end tax reporting and concluded they were and continue to be adequate, with few exceptions, in that it is common to have the individual(s) performing the payroll function to also prepare year-end 1099 reporting. However, to mitigate risk, Eastpointe has separated the accounts payable function which, prior to the change, was also done by the individual responsible for the payroll function and year-end tax reporting.

We detected possible unlawful activity through our internal investigation procedures and noted that certain vendor's 1099 reporting did not agree with our history of payments but had in fact been altered as admitted during our interview of the former Manager of Accounting Services. Specifically, based on our interview, the former Manager of Accounting Services indicated that at the direction of the former CFO, she altered the Great Plains system records for certain related party vendors, causing 1099s to be underreported. She also stated that at the request of the former CFO, she showed the former CFO how to alter the Great Plains system to change what would be reported as non-employee earnings on 1099 forms. She acknowledged that the former CFO intended to change accounting records for a certain named vendor and that the former CFO may have changed accounting records for another certain named vendor. Through its investigation, OSA confirmed vendor kickback activity as a result of its interviews of certain vendors and other investigative techniques.

Based on the results of our internal forensic investigation and assessment of our internal controls, we concluded that the former CFO systematically circumvented, overrode and

inappropriately used his position to influence other employees and vendors to exploit our system of internal controls for apparent personal gain.

Eastpointe has, over time, implemented a series of internal controls to mitigate various risks including the findings identified in the Eastpointe Report and the OSA Report. With respect to these internal controls, it is important to note that “virtually all systems of internal control are subject to management override, and collusion by two or more parties acting together to circumvent the system of control.” See COSO, Committee of Sponsoring Organizations of the Treadway Commission, Internal Control – Integrated Framework (2013). In any event, a more robust periodic monitoring and testing of internal controls could have led to earlier detection of the misappropriation. The CEO and the Board have placed enhanced emphasis on oversight of the following:

- Hotline Reporting
- The Eastpointe Code of Conduct
- Compliance function monitoring activities
- Capital budgets and expenditures (including construction projects and major asset purchases)
- Operational budgets and expenditures (including vehicle leases)
- Executive expense reporting
- Use of Eastpointe credit cards
- Use of Eastpointe vehicles
- Fraud risk awareness training and review of best practices in governance and anti-fraud controls

The Board continues to evaluate expanding the role of its Risk Committee to, among other things, considering monthly “red flag” or suspicious activity reports, augmenting the compliance function and establishing an internal audit function. In addition, the Board will consider establishing requirements for senior financial officers (CEO and CFO) to annually reaffirm to a separate code of ethics given the roles of responsibility and influence on the system of internal control.

**FINDING NO. 8: FORMER CFO, CEO AND OTHER EMPLOYEES USED EASTPOINTE CREDIT CARDS TO MAKE \$157,565 OF QUESTIONABLE PURCHASES**

**OSA RECOMMENDATIONS:**

- Eastpointe’s board of directors should establish a comprehensive policy for the assignment and use of credit cards.
- Eastpointe’s board of directors should ensure that its CEO establishes monitoring tools to identify unusual financial activity trends associated with direct subordinates.
- As a check signer, the CEO should thoroughly review documentation supporting disbursements prior to signing checks.

**Eastpointe Response to OSA Finding No. 8:**

See the Preliminary Statement set forth above and incorporated in this response as if fully set forth herein. It should be noted that the current composition of the Board is substantially different from the composition of the Board when the activities giving rise to this finding occurred. Notwithstanding, the currently constituted Board authorized the internal forensic investigation and the organizational internal control assessment completed in July 2014 and disclosed to the District Attorney in July 2014, the SBI in July 2014, and OSA in September 2014.

The Board and Management will review governance and internal controls including Eastpointe’s policies and procedures to procure and pay for goods and services. We continue to evaluate and strengthen our monitoring controls to include policies outlining the types of transactions that require Board approval and a system of internal controls that require management to inform the Board of significant transactions. The CEO and the Board will ensure adequate oversight of the following:

- Hotline Reporting
- The Eastpointe Code of Conduct
- Compliance function monitoring activities
- Capital budgets and expenditures (including construction projects and major asset purchases)
- Operational budgets and expenditures (including vehicle leases)
- Use of Eastpointe credit cards
- Use of Eastpointe vehicles
- Fraud risk awareness training and review of best practices in governance and anti-fraud controls

The Board continues to evaluate expanding the role of its Risk Committee to, among other things, considering monthly “red flag” or suspicious activity reports, augmenting the compliance function and establishing an internal audit function. In addition, the Board will consider establishing requirements for senior financial officers (CEO and CFO) to annually reaffirm to a

separate code of ethics given the roles of responsibility and influence on the system of internal control.

Further, the Board acknowledges and agrees that the CEO must perform an appropriate review of the underlying supporting documentation in accordance with Eastpointe policies before signing a check and maintain appropriate control over the use of signature stamps.

With respect to questionable expenditures raised by OSA regarding Eastpointe's CEO, there has been no validation that any such expenditures were personal in nature. On an annual basis, accountants representing DHHS review a sample of credit card expenditures for settlement purposes. When errors are found, Eastpointe settles any payments owed to DHHS. In the event administrative expenditures exceed the State allocation, the overage is covered by local funds as part of the settlement process with the State. Notwithstanding the foregoing, Eastpointe has formally requested DHHS to review OSA questioned expenditures previously settled. In the event DHHS determines that any portion of the OSA questioned expenditures are not allowable, Eastpointe will reimburse the same.

In addition, the Board did address and reassert with the CEO his executive leadership responsibilities including receipt requirements for all expenses incurred on behalf of Eastpointe. The Board has increased its oversight in this area through monitoring executive expense reporting via the Compliance Officer and at Board Finance Committee meetings. In addition, Eastpointe will work with the awarding agencies to determine whether a refund of the questioned expenditures is required. As stated above, Eastpointe has formally requested DHHS to review OSA questioned expenditures previously settled by DHHS. In further response to Finding No. 8, Eastpointe states that the OSA questioned CEO expenditures, upon appropriate review, are legitimate organizational expenses.

**FINDING NO. 9: PERSONAL USE OF EASTPOINTE VEHICLES NOT REPORTED AS TAXABLE FRINGE BENEFIT TO CEO, FORMER CFO, AND FACILITIES MAINTENANCE MANAGER**

**OSA RECOMMENDATIONS:**

- Eastpointe’s board of directors should evaluate whether commuting or other personal use of Eastpointe vehicles is a prudent use of taxpayer funds.
- Eastpointe’s board of directors should require either the repayment of benefits or the amendment of Internal Revenue Service Wage and Tax Statements to reflect the taxable fringe benefit derived from the private use of publicly-owned vehicles.
- Eastpointe’s board of directors should revise its travel policy to address personal use of Eastpointe vehicles.
- Eastpointe management should ensure that all vehicle have mileage logs, require all staff to track the purpose/use of organization vehicles, and review the logs on a monthly basis.

**Eastpointe Response to OSA Finding No. 9:**

See the Preliminary Statement set forth above and incorporated in this response as if fully set forth herein. It should be noted that the current composition of the Board is substantially different from the composition of the Board when the activities giving rise to this finding occurred.

Notwithstanding, the currently constituted Board authorized the internal forensic investigation and the organizational internal control assessment completed in July 2014 and disclosed to the District Attorney in July 2014, the SBI in July 2014, and OSA in September 2014.

The Board and Management will continue to review governance and internal controls including Eastpointe’s policies and procedures to procure and pay for goods and services, travel/agency vehicle use and employee compensation/benefit issues. We continue to evaluate and strengthen our monitoring controls to include development of policies outlining the types of transactions that require Board approval and a system of internal controls that require management to inform the Board of significant transactions, including employee compensation, travel and use of agency vehicles. The following controls have been strengthened including adequate oversight of the following:

- Operational budgets and expenditures (including vehicle leases)
- Use of Eastpointe vehicles
- Eastpointe vehicle records to ensure use and monthly monitoring of mileage logs

Eastpointe will determine the extent to which Eastpointe is required to report to the IRS and state any taxable benefit associated with employee use of agency vehicles.



**FINDING NO. 10: FEDERAL REQUIREMENT TO TAG AND INVENTORY EQUIPMENT NOT PRACTICED**

**OSA RECOMMENDATIONS:**

- Eastpointe's management should tag fixed assets with a control number that is affixed in a permanent manner.
- Eastpointe management should perform an annual physical inventory of its fixed assets.

**Eastpointe Response to OSA Finding No. 10:**

See the Preliminary Statement set forth above and incorporated in this response as if fully set forth herein. It should be noted that the current composition of the Board is substantially different from the composition of the Board when the activities giving rise to this finding occurred. Notwithstanding, the currently constituted Board authorized the internal forensic investigation and the organizational internal control assessment completed in July 2014 and disclosed to the District Attorney in July 2014, the SBI in July 2014, and OSA in September 2014.

Eastpointe will tag fixed assets and perform an annual physical inventory of its fixed assets in accordance with applicable law to ensure compliance.

**FINDING NO. 11: INADEQUATE CEO AND BOARD OVERSIGHT CONTRIBUTED TO OPERATIONAL FAILURES**

**OSA RECOMMENDATIONS:**

- Eastpointe’s CEO and board of directors should assess and improve their oversight and procedural compliance to reduce the risk of operational failures.
- Eastpointe’s board of directors should seek guidance from an independent expert to assist with the design and implementation of an effective internal control system.

**Eastpointe Response to OSA Finding No. 11:**

See the Preliminary Statement set forth above and incorporated in this response as if fully set forth herein. See also responses to Finding Nos. 1, 2, 3, 4, 5, 6, 7, 8, 9 and 10. It should be noted that the current composition of the Board is substantially different from the composition of the Board when the activities giving rise to this finding occurred.

Notwithstanding, the currently constituted Board authorized the internal forensic investigation and the organizational internal control assessment completed in July 2014 and disclosed to the District Attorney in July 2014, the SBI in July 2014, and OSA in September 2014.

Based on the results of Eastpointe’s internal forensic investigation and assessment of our internal controls, we concluded that the former CFO systematically circumvented, overrode, and inappropriately used his position to influence other employees and vendors to exploit our system of internal controls for apparent personal gain.

It is also important point out that the cost of building renovations during the relevant period of time is \$1,391,210 rather than \$2,830,924. The relevant period of time for purposes of the OSA investigation is fiscal years FY 2011-2013. The \$2,830,924 covered the period of time from FY 2009 to 2014 and erroneously includes costs related to the Kenansville site.

Eastpointe has, over time, implemented a series of internal controls to mitigate various risks including the findings identified in the Eastpointe Report and the OSA Report. With respect to these internal controls, it is important to note that “virtually all systems of internal control are subject to deterioration over time, management override, and collusion by two or more parties acting together to circumvent the system of control.” See COSO, Committee of Sponsoring Organizations of the Treadway Commission, Internal Control – Integrated Framework (2013). In any event, a more robust periodic monitoring and testing of internal controls could have led to earlier detection of the misappropriation. The CEO and the Board have placed enhanced emphasis on oversight of the following:

- Hotline Reporting
- The Eastpointe code of conduct
- Compliance function monitoring activities

- Capital budgets and expenditures (including construction projects and major asset purchases)
- Operational budgets and expenditures (including vehicle leases)
- Executive expense reporting
- Use of Eastpointe credit cards
- Use of Eastpointe vehicles
- Fraud risk awareness training and review of best practices in governance and anti-fraud controls

In addition, the Board continues to evaluate expanding the role of its Risk Committee to, among other things, considering monthly “red flag” or suspicious activity reports, augmenting the compliance function and establishing an internal audit function. In addition, the Board will consider establishing requirements for senior financial officers (CEO and CFO) to annually reaffirm to a separate code of ethics given the roles of responsibility and influence on the system of internal control.

In January of 2014, management, with Board approval, engaged outside consulting experts to perform an internal control review and gap assessment of Eastpointe’s antifraud program and controls including its governance oversight. The results of the initial gap assessment and remediation plan were presented to the Finance Committee of the Board in April 2014. Eastpointe continues to work with outside experts to ensure the design and implementation of our internal control remediation plan provides for an effective system of internal control.

Notwithstanding the foregoing, Eastpointe’s external auditors did not disclose any material internal control deficiencies in connection with any audit report submitted to the Board during any relevant time.

# ORDERING INFORMATION

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Office of the State Auditor  
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20601 Mail Service Center  
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For additional information contact:  
Bill Holmes  
Director of External Affairs  
**919-807-7513**

