STATE OF NORTH CAROLINA

Office of the State Auditor

2 S. Salisbury Street
20601 Mail Service Center
Raleigh, NC 27699-0601
Telephone: (919) 807-7500
Fax: (919) 807-7647
Internet http://www.osa.state.nc.us

Ralph Campbell, Jr.
State Auditor

April 10, 2000

Dr. H. David Bruton, Secretary
Department of Health and Human Services
101 Blair Drive
Raleigh, NC 29526

Dear Dr. Bruton:

At your request, supplemented by a request from the legislature, we have completed a special review of retroactive Thomas S payments made by the Division of Mental Health, Developmental Disabilities, and Substance Abuse Services during fiscal year 1998-99. The specific objectives of this review were to:

- Determine the Division's philosophy on how to serve Thomas S clients, determine how decisions are made on individual clients, and the average costs per client;
- Determine procedures followed by the Division for setting the residential rates and whether any fraud was involved in the retroactive rate setting process; and
- Determine the financial impact of the retroactive payments to include the amount of retroactive payments made to the area programs.

To accomplish these objectives, we reviewed the preliminary work done by the Department of Health and Human Services' (DHHS) Internal Audit section. We interviewed key personnel from the Division of Mental Health, Developmental Disabilities, and Substance Abuse Services (Division), including Thomas S program personnel, and personnel from the DHHS Controller's office. We conducted a telephone survey of the 39 area programs. Lastly, we conducted a thorough review of the available documentation and financial records surrounding the retroactive rate increase. This review was conducted in accordance with the *Government Auditing Standards* issued by the Comptroller General of the United States.

FINDINGS IN BRIEF

We found that the Division did not follow established procedures in setting the retroactive residential rates. However, we found no evidence of fraud in the actions taken. We did find, however, what we believe to be a manipulation of regulations that resulted in an increase of $9,014,757 allotted to area programs. All indications are that the Thomas S section chief, with the implicit approval of Division management, made the decision to increase rates, and subsequently payments to area programs, in an effort to prevent unallocated Thomas S funds held at the State level from reverting to the State's General Fund. This decision reduced the amount of Thomas S funds that would have reverted to the General Fund from $13,159,554 to $4,144,797, in effect moving Thomas S funds from the State level and "protecting" those funds at the area program level. The area programs restricted fund balances increased by a net amount of $7,799,771 as a direct result of the rate revision. Subsequently, the Department changed its policy on the restricted fund balances and reduced the fiscal year 1999-00 Thomas S allocations, requiring the area programs to budget their Thomas S restricted funds to provide services. Division records indicate that $70,946,403 was paid to the area programs for Thomas S Unit Cost Reimbursement services during fiscal year 1998-99. However, precise dollar amounts of earnings and expenditures cannot be verified until after the area programs submit the March 31, 2000 settlement reports to the Division. At that time, DHHS Internal Audit should conduct a thorough examination of the cost settlement reports. Below we discuss our findings and conclusions in detail.

Thomas S Class Members: Service Philosophy, Procedures, and Client Costs

On November 21, 1988, the US District Court ruled that the Secretary of DHHS had violated the constitutional rights of a class of individuals who were, or had been, confined to the State's psychiatric hospitals. These individuals, known as the Thomas S class, had resided in one of the State's psychiatric hospitals on or after March 22, 1984, and had a diagnosis of mental retardation or had been treated as such.

On January 7, 1991, the District Court appointed a Special Master to monitor the implementation of the Court's November 1988 Order and to hear disputes between the parties arising out of implementation activities. Further, the District Court appointed an independent evaluator on January 14, 1991.

On February 4, 1994, the Court approved an agreement between parties in the Thomas S case. The agreement served to narrow the scope of the Thomas S class, create an alternative process for identifying class members, permit DHHS to demonstrate its ability to conduct current needs assessments, and evaluate service planning and implementation for class members without the use of the independent evaluator.

On December 21, 1995 the State filed a petition with the United States District Court to terminate the office of the Special Master. On January 24, 1998, the Court granted the State's petition on the grounds that the State had corrected the deficiencies cited in the 1988 court order through the establishment of the Thomas S services delivery system, thus federal court oversight and monitoring were no longer necessary. The Division is currently administering the Thomas S program under the policies and procedures established during the court order.

The Division's philosophy for Thomas S class members is to empower persons with challenging multiple disabilities to live in the communities of their choice. Clients are provided an array of appropriate and flexible support, services, and treatment options. This enables a quality of life characterized by satisfaction, inclusion, friendship, acceptance, and productivity. The area mental health programs have the primary responsibility for delivering client services.

Decisions are made locally at the area programs for each Thomas S client based on **individual service plans** developed by appropriate professionals who evaluate each client's needs. These evaluations are based on established medical criteria which has been approved by the Division. The area programs, in accordance with the Division's policies and procedures, then administer service plans. Table 1 shows the number of clients served and the total **State amounts appropriated** for fiscal years 1989-90 through 1998-99. The majority of the Thomas S funds are allocated to the area programs via an annual Letter of Allocation. This letter identifies the individuals to be supported with the funds allocated.

TABLE 1
Average Cost Per Client (State Funds Only)

Fiscal Year	State Appropriations	Clients Served	Average Cost per Client
89-90	$1,500,000	60	$25,000
90-91	4,500,000	96	46,875
91-92	12,200,000	155	78,710
92-93	16,700,000	252	66,270
93-94	28,100,000	400	70,250
94-95	41,400,000	651	63,594
95-96	43,600,000	898	48,552
96-97	74,200,000	1087	68,261
97-98	84,592,290	1166	72,549
98-99	93,471,247	1276	73,253
For fiscal year 1999-00, there are 1,281 clients being served at a cost of $90,770,826 through March 30, 2000.			
Source: Division of Mental Health, Developmental Disabilities and Substance Abuse Services			

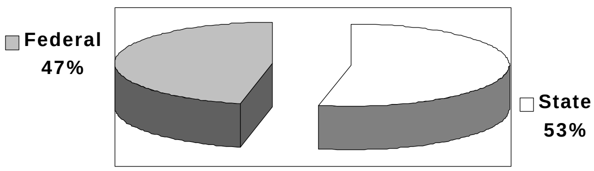
Table 2 shows a breakdown of costs per client by $10,000 increments for FY98-99 for all clients including ones receiving only case management services. These are the **total State dollars plus the total Medicaid dollars.** These totals <u>*do not include*</u> any personal income, SSI, or SSA funds that these individuals may have received. That data can only be obtained through extensive analysis from several different programs. Due to time limitations, we were not able to

TABLE 2
Total Cost Range of Clients
Per Unique Identification Number
For FY98-99

Range	# of Clients	Range	# of Clients
$0 - $10,000	224	$140,000 - $149,999	71
$10,050 - $19,999	112	$150,000 - $159,999	68
$20,000 - $29,999	79	$160,000 - $169,999	40
$30,000 - $39,999	62	$170,000 - $179,999	35
$40,000 - $49,999	63	$180,000 - $189,999	35
$50,000 - $59,999	70	$190,000 - $190,999	14
$60,000 - $69,999	85	$200,000 - $209,999	14
$70,000 - $79,999	85	$210,000 - $219,999	6
$80,000 - $89,999	89	$220,000 - $229,999	6
$90,000 - $99,999	93	$230,000 - $229,999	6
$100,000 - $109,999	103	$240,000 - $299,999	9
$110,000 - $119,999	75	$415,000 - $419,999	1
$120,000 - $129,999	71		
$130,000 - $139,999	97	Total	*1613
*Also includes clients receiving only case management services.			
Source: DMHDDSAS			

obtain this information. As can be seen, For FY98-99, there were 1,613 Thomas S. clients who received a total of $135,342,605 (including adjustments made after the end of the fiscal year) in State Thomas S. and Medicaid funds ($72,128,862 State and $63,213,743 Medicaid). Exhibit 1 shows the division of funds for these clients.

EXHIBIT 1
Breakdown of Funding for Thomas S. Clients



Source: DMHDDSAS

Conclusion: The Division has established policies and procedures in place to monitor the provision of services to members of the Thomas S class. These procedures appear to be sufficient to assure that the services are provided and that the funds are accounted for. As can be seen in Table 1, the average State costs per client have increased 193% since the program began in 1989-90. For FY98-99, the State was providing 53% of the funding for Thomas S. clients, with costs for individual clients ranging from a high of $419,370 to a low of $10.38.

Rate Setting Procedures and the Retroactive Rates

The 1993 Session of the General Assembly passed a Special Provision requiring the development of a unit cost method of reimbursement for the Thomas S clients. The Division developed the Unit Cost Reimbursement System-Thomas S (UCR-Thomas S) and established several goals:

1. Modify the existing Pioneer System to accommodate tracking services provided to each Thomas S client on a unit cost basis;
2. Collect and process services, earnings, and payment information;
3. Pay area programs based on UCR-Thomas S earnings; and
4. Base area programs year-end financial settlements on UCR-Thomas S earnings.

Area Programs earn money by providing billable services to Thomas S clients based on specified rates per unit. These bills are submitted electronically to the Division for reimbursement. The Division makes advances to the area program in July and August in an amount equal to estimated expenses. These advances are recovered from payable earnings during the course of the year. In September and subsequent months, area program payments are based upon earnings calculated by the UCR-Thomas S system. Table 3 shows the total State payments made to the area programs for the past three fiscal years. Any advances, payments, earnings, or adjustments not accounted for during the fiscal year are reconciled in a year end settlement.

TABLE 3
Total Thomas S State Payments to Area Programs

Fiscal Year	Total Payments
96-97	$61,974,779
97-98	$73,822,870
98-99	$82,149,313

Source: DMH/DD/SAS

Over the course of the year, payments are made to area programs based upon earnings or funds requested. Following the area program's annual audit, the Division's regional accountants review the audited Thomas S expenses. If Thomas S **earnings do not exceed Division payments**, the Division recovers the difference between earnings and payments as part of the "Tentative Settlement Report." If Thomas S **earnings equal or exceed payments, and payments exceed expenditures,** the excess of Division payments over expenditures must be held by the area program as a *restricted Thomas S fund balance*. These funds must be used for services to Thomas S clients.

As specified in the Special Provision for Thomas S, the rates for services for Thomas S class members should "reflect reasonable costs" as identified through, "rate comparisons and cost center line item budget reviews." The Division conducts annual cost findings based upon year-end actual expenditures and operating information. All rates are approved by the Division prior to the rate being used as the basis for UCR-Thomas S payments.

Each fiscal year begins with interim UCR-Thomas S rates, the end of year "generic" rates from the previous year. When new rates are approved, they are retroactively applied. Payments that have already been processed are recalculated using the new approved rates. An area program can request additional rates if the quantity of services provided increases over what was expected, or updates if the cost of the services decrease. We found that the fiscal year 1998-99 retroactive residential rate increases implemented in May 1999 were **determined without a thorough study of the actual costs of services provided by the area programs.**

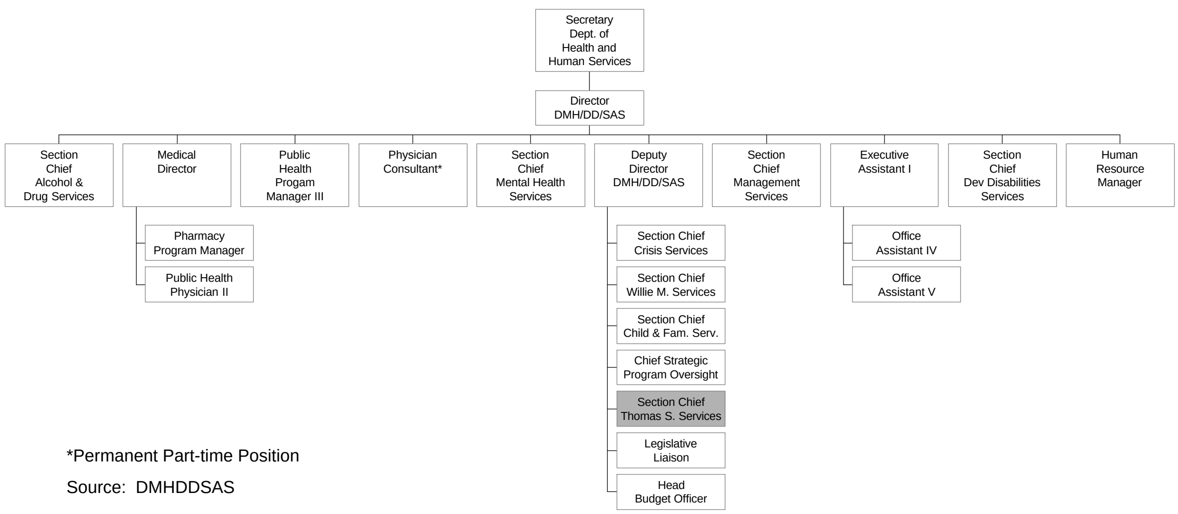
Documentation shows that the Division of Medical Assistance (DMA) conducted a cost analysis of the Client Behavior Intervention (CBI) rates, and found, as reported in its *Cost Finding Review* report dated July 1998, that these rates were significantly inflated. Subsequently, DMA reduced the rate for CBI from $37.04 to $21.20 per hour. When Thomas S residential rates were established in 1998, it was assumed that a certain level of service and income would be generated via CBI Medicaid billings to support clients in residential services. After the DMA *Cost Finding Review,* the Division and DMA increased monitoring of Medicaid billable services. Area programs and providers were told that the billing of large blocks of CBI time was not appropriate. Area programs and providers responded to these directions by decreasing the number of CBI hourly units billed to Medicaid. From December 1997 to May 1999, monthly Medicaid CBI hourly billings decreased in both units provided and Medicaid payments for Thomas S clients. Table 4 shows the total units reported for fiscal years 1997-98 and 1998-99 and the net dollar amount paid.

TABLE 4
CBI Billings and Payments

Fiscal Year	Units Reported	Amount Paid
97-98	2,662,849	$21,789,986
98-99	2,531,949	$13,669,662
Source: DMHDDSAS		

Documentation shows that the Thomas S section chief believed that the CBI rate decrease was a DMA decision to provide CBI services for the same rate as Client Intervention services. According to documentation, the section chief believed this to represent a major shift in Medicaid policy. To help offset decreases in Medicaid funding, the Thomas S section chief initiated a residential rate increase. This action was within her authority since the section chief was charged with the responsibility of setting rates, per the Thomas S *Funding System Manual*. The manual also states that the Division management must approve all rates prior to use as a basis for UCR-Thomas S payments. At the time of these actions, the section chief reported directly to the Deputy Director for the Division. See Exhibit 2.

EXHIBIT 2
DEPARTMENT OF HEALTH AND HUMAN SERVICES
DIVISION of MH/DD/SAS



*Permanent Part-time Position

Source: DMHDDSAS

While Division management was kept aware of the residential rate change decision through e-mail, formal procedures were not followed in the implementation of the rate change. Specifically, we did not find adequate documentation to support the need for increased rates, nor did we find any specific analysis of actual costs for these services as required by the funding system procedures. (See discussion in "Financial Impact" section that follows.)

Conclusions: **The Division has specific procedures in place for rate setting for the Thomas S program. The initial CBI rates were found to be significantly inflated based on a cost analysis performed by DMA. Subsequently, CBI Medicaid rates for Thomas S clients were reduced, and area programs were told not to bill large blocks of time to this service code. This resulted in reductions in Medicaid reimbursements to the area programs for Thomas S clients. Because of these reductions, the Thomas S section chief determined a need to increase the Thomas S residential rates retroactively for the entire fiscal year to help offset the reduced Medicaid reimbursements. However, the documentation supplied by the Division did not clearly show the need for this increase, nor did the Division**

provide evidence of a cost analysis to support this increase. Since the Thomas S section chief was acting within her authority in making a change in the rate, we found no evidence of fraud in these actions.

Recommendation: Rate setting is an accounting function that should be the responsibility of the DHHS Controller's Office. The Controller's Office should perform annual cost analysis and budget reviews of the area programs. Based on this data, the Controller's Office should set the rates for Thomas S services. This change will strengthen internal controls and increase separation of duties. DHHS has already taken steps to implement this recommendation.

Financial Impact of the Retroactive Residential Rate Increase

The residential rate increase affected the Thomas S supervised living residents represented by service codes 811-816. A rate for each service is established at the beginning of the fiscal year based upon interim UCR-Thomas S rates, as explained above. These rates are then used to determine the dollar amount to be received by area programs for services rendered. The residential rates were changed to:

- Reflect inflationary changes;
- Raise the allowance for full time employees from 3 FTEs to 3.5;
- Raise the food allowance from $200 to $300 per month;
- Increase the lawn maintenance; and
- Increase travel allowance from 50% to 100%.

Table 5 shows the differences in the unit rates after the increase. This action resulted in area program earnings for these service codes increasing from $30,193,182 to $39,207,938. According to information provided by the Thomas S section chief, she initiated the rate increase to provide *additional requested funds to cover unreimbursed expenses incurred by Thomas S service providers* for fiscal year 1998-99; and to offset the decrease in Client Behavior Intervention (CBI) Medicaid funding.

TABLE 5
Comparison of Cost Per Units at the Old and New Rate

Daily Cost Per Client	811 1 Bed	812 2 Beds	813 3 Beds	814 4 Beds	815 5 Beds	816 6 Beds
New Rate	$316	$179	$127	$100	$ 84	$ 74
Old Rate	$258	$138	$ 99	$ 78	$ 66	$ 58
Rate Increase	$ 58	$ 41	$ 28	$ 22	$ 18	$ 16
% Increase	22.39%	29.48%	28.31%	28.16%	27.69%	28.17%

Source: DMHDDSAS

TABLE 6
Results of Telephone Survey

Questions	Yes	No	No Response
Have you expended your initial Thomas S allocation for FYE 1999?	23 (59%)	13 (33%)	3 (8%)
Are you familiar with the retroactive residential rate increase made in May 1999?	38 (97%)	0 (0%)	1 (3%)
Did you request and/or receive any retroactive reimbursements for residential services as a result of the May 1999 residential rate change?	8 (21%)	30 (77%)	1 (3%)

Source: Compiled by the Office of the State Auditor

We have documented in the previous section the decrease in the CBI rates and the effect that had on the area programs. However, the Division was not able to provide any documentation showing requests from providers for rate increases. To determine whether area programs had requested additional funds to cover unreimbursed costs incurred by providers, we conducted a telephone survey of all area programs. The service providers have direct contracts with the area programs to provide specific Thomas S services at established rates. Therefore, we reasoned that the providers would have contacted the area programs first to try to increase the rates.

We found, as shown in Table 6, that only 8 of the 39 area programs (21%) have requested additional funds. **These requests were made only after the residential rate increase was implemented**. Specific instructions were sent to the area programs from the Thomas S section chief to contact providers to determine legitimate unreimbursed expenses during 1998-99. Table 7 shows the amounts that the eight area programs reimbursed Thomas S service providers as a result of the rate increase. The financial impact of the rate increase caused area program's potential earnings to increase $9,014,757. See Table 8. The residential rate increase also affected the potential dollar amounts that could have reverted to the State's General Fund, reducing it from $13,159,554 to $4,144,797.

TABLE 7
Retroactive Rate Increase Payments to Thomas S Service Providers

Area Program	Number of Providers	Amount
Albermarle	1	$ 5,153
Foothills	3	299,034
Gaston-Lincoln-Cleveland	2	132,396
Johnston	3	57,978
Piedmont	1	300,000
Wake	4	195,795
Southeastern Regional	7	224,630
Total	**21**	**$1,214,986**

Source: Area Programs, Compiled by the Office of the State Auditor from Survey Results

According to Division records, actual payments made to the area programs for fiscal year ending June 30, 1999 amounted to $70,946,403. See Table 9. Precise dollar amounts of earnings and expenditures cannot be verified until after the area programs submit their "Tentative Settlement Reports" (TSR) to the Division which were due March 31, 2000. The TSR is a summary of the earnings of area programs compared to payments made by the Division for UCR services. Also, the TSR compares the expenditures of area programs to payments made by the Division for non-UCR activities.[1]

TABLE 8
EFFECT ON AREA PROGRAM EARNINGS AND REVERSIONS

	Before Rate Increase	After Rate Increase	Difference
Budget/Allocation Per UCR units	$75,335,582	$75,335,582	$ -0-
Total Potential Earnings Due the Area Program	62,176,028	71,190,785	9,014,757
Amount that could have reverted to State General Fund	13,159,554	4,144,797	9,014,757

Source: DMHDDSAS

[1] The TSR is prepared based upon units billed through June 30 of each fiscal year. However, area programs are allowed to make adjustments and corrections to the UCR system through September 30. This may cause a difference in the earnings and the payment amounts to the area programs, thus necessitating the TSR procedures.

TABLE 9 Payments Made to Area Programs	
Total Earnings Due to Area Program Using the New Rate	$71,189,218
Payments to Area Programs	70,946,403
Difference	$ 242,815
Source: DMHDDSAS	

As noted earlier, if Thomas S payments exceed expenditures, the excess must be held in a restricted Thomas S fund balance. The information presented above indicates that the area programs restricted fund balances increased by $7,799,771 (the potential earnings of $9,014,757 less the amount of the retroactive increase actually paid to providers, $1,214,986). Currently area programs are allowed to retain a Thomas S restricted fund balance equivalent to 8% of their current UCR allocation. (Prior to December 1999, the Department did not have any restrictions on the amounts the area programs could maintain in their Thomas S restricted fund balances.) For fiscal year 1999-00, 8% would equal $6,126,481. At September 30, 1999, area programs were reporting a Thomas S fund balance of $14,202,523, some $8,076,042 over the allowed 8%.

Review of budget data revealed that the Division requested significantly more Thomas S funds that the General Assembly appropriated for fiscal years 1997-98 through 1999-00. The Division was aware of this difference at the time the General Assembly approved its budget for those fiscal years. Memoranda from the Division Director and the Thomas S section chief indicate that they considered the difference in what was requested and what was appropriated to be a "shortfall." Table 10 shows the amounts requested by the Division and the amounts actually appropriated by the General Assembly. In May 1999, there was a $13 million excess of unallocated funds at the State level. These funds would have reverted to the State's General Fund if still unappropriated at the end of the fiscal year, thus further reducing the funds available to be used to directly support Thomas S clients. In effect, the decisions made relative to the rate revision moved Thomas S funds from the State level and "protected" those funds at the area program level. The Division later "retrieved" these protected funds by requiring the area programs to budget the fund balances as explained below.

TABLE 10
Division Budget Requests and Appropriations for FY97-98 through FY99-00

Fiscal Year	Total Budget Requested	Total Budget Appropriated	Difference
97-98	$88,043,989	$71,152,063	$(16,891,926)
98-99	101,226,739	92,693,623	(8,533,116)
97-98	93,319,369	89,623,224	(3,696,145)
Totals	$282,590,097	$254,468,910	($29,121,187)
Source: DMHDDSAS Budget Records			

In a letter dated December 8, 1999, at the direction of the Secretary, the Division stated that area programs with a positive Thomas S restricted fund balance in excess of the allowed 8% would have their State Thomas S allocations reduced. The difference would come from the restricted fund balance. Department policy was changed to require area programs to budget the amount of Thomas S fund balance in excess of the allowed 8%. Table 11, page 10, shows beginning fund balances, by area program, and the net effect on fund balance and allocations as a result of the reduction.

TABLE 11
Effect of Allocation Reduction on Fund Balances

1	2	3	4	5	6	7	8
Area Programs	FY99-00 Allocation	Allowable 8% of Allocation	Fund Balance at 9/30/99	Less: Approved Expenditures	Amount of Reduction ((Col. 4 – Col. 5) -Col. 3)	Remaining Fund Balance After Reduction	Adjusted FY99-00 Allocations
Alamance-Caswell	1,908,200	152,656	762,740	(24,689)	585,395	177,345	1,322,801
Albemale	1,590,000	127,200	1,555,618	(18,765)	1,409,653	145,965	180,347
Blue Ridge	1,769,000	141,520	15,540	(156)	0	15,540	1,769,000
Catawba	1,420,297	113,624	213,421	0	99,797	113,624	1,320,500
CenterPoint	1,918,361	153,469	0	0	0	0	1,918,361
Crossroads	1,482,232	118,579	0	0	0	0	1,482,232
Cumberland	915,027	73,202	394,023	(15,050)	305,771	88,252	609,256
Davidson	1,592,249	127,380	356,731	(40,826)	188,525	168,206	1,403,724
Duplin-Sampson	952,000	76,160	169,071	(65,918)	26,993	142,078	925,007
Durham	1,477,151	118,172	136,748	(374)	18,202	118,546	1,458,949
Edgecomb-Nash	2,387,086	190,967	547,309	0	356,342	190,967	2,030,744
Foothills	3,033,470	242,678	85,382	(16,065)	0	85,382	3,033,470
Gaston-Lincoln-Cleveland	5,969,813	477,585	92,934	0	0	92,934	5,969,813
Guilford	3,797,457	303,797	1,760,543	0	1,456,746	303,797	2,340,711
Johnston	510,595	40,848	350,877	(18,142)	291,887	58,990	218,708
Lee-Harnett	959,948	76,796	106,246	(19,250)	10,200	96,046	949,748
Lenoir	573,070	45,846	0	(83,160)	0	0	573,070
Mecklinburg	3,474,439	277,955	0	0	0	0	3,474,439
Neuse	1,475,857	118,069	0	0	0	0	1,475,857
New River	1,320,847	105,668	155,650	0	49,982	105,668	1,270,865
Onlsow	620,500	49,640	405,009	(9,000)	346,369	58,640	274,131
OPC	3,485,430	278,834	595,000	0	316,166	278,834	3,169,264
Piedmont	4,057,981	324,638	358,436	(27,820)	5,978	352,458	4,052,003
Pitt	1,522,897	121,832	0	0	0	0	1,522,897
Randolph	1,508,187	120,655	615,649	(7,725)	487,269	128,380	1,020,918
RiverStone	1,331,684	106,535	525,729	(9,100)	410,094	115,635	921,590
Roanoke-Chowan	1,472,175	117,774	960,163	0	842,389	117,774	629,786
Rockingham	1,475,305	118,024	413,467	(18,000)	277,443	136,024	1,197,862
Rutherford-Polk	1,038,689	83,095	372,874	0	289,779	83,095	748,910
Sandhills	2,355,369	188,430	664,296	(111,400)	364,466	299,830	1,990,903
Smoky Mountain	2,244,500	179,560	407,427	(3,088)	224,779	182,648	2,019,721
Southeastern Area	3,066,090	245,287	515,000	0	269,713	245,287	2,796,377
Southeastern Regional	2,885,452	230,836	673,799	(104,660)	338,303	335,496	2,547,149
Tideland	773,500	61,880	0	0	0	0	773,500
Trend	978,745	78,300	6,000	0	0	6,000	978,745
VGFW	2,628,000	210,240	0	0	0	0	2,628,000
Wake	3,703,854	296,308	0	0	0	0	3,703,854
Wayne	1,262,135	100,971	0	0	0	0	1,262,135
Wilson-Greene	1,643,391	131,471	986,841	(970,448)	0	986,841	1,643,391
Totals	**76,580,979**	**6,126,481**	**14,202,523**	**1,563,635**	**8,972,241**	**5,230,282**	**67,608,738**

Source: DMHDDSAS

Conclusion: **The residential rate increase had the result of allowing potential earnings for area programs to increase by $9.0 million. The rate increase also had the effect of reducing the Division's amount of reversion to the State's General Fund from $13.2 million to $4.1 million. At the same time, the restricted fund balances for the area programs increased by $7.8 million because of these rate increases. We were unable to find adequate documentation to support the justification used for the retroactive rate increase, i.e., that Thomas S service providers had incurred unreimbursed costs. In fact, only 8 of the 39 area programs have used any of the retroactive funds. As a result of the Division's actions, area programs had significant amounts of Thomas S funds in their fund balances. The Department changed its policy to require that those funds be budgeted for Thomas S services and reduced the area programs' fiscal year 1999-00 allocations accordingly. Therefore, the decision to increase rates significantly reduced the amount of Thomas S funds that would have reverted to the State's General Fund.**

Recommendation: DHHS Internal Audit should perform a review of the "Tentative Settlement Reports" as soon as possible after the March 31, 2000 submission date to determine the exact dollar impact of the residential rate increase on area programs and their service providers. Additionally, DHHS should review its budgeting procedures to assure that all divisions are in compliance with State budgetary policies.

In accordance with our policies and procedures, we request that your office provide us with a written response to the issues identified in this management letter. The response should be delivered to this office no later than Wednesday, April 19, 2000, in order to be included with the distribution of this management letter.

If you wish to discuss any of the issues above, please let us know. We appreciate the courtesy, cooperation, and assistance provided to us during this review by your staff.

Sincerely,

Ralph Campbell, Jr.

Ralph Campbell, Jr.
State Auditor

Management letters and responses receive the same distribution as audit reports.

(This page left blank intentionally.)

North Carolina Department of Health and Human Services
2001 Mail Service Center Raleigh, North Carolina 27699 -2001
Tel 919-733-4534 Fax 919-715-4645 Courier 56-20-00

James B. Hunt Jr., Governor H. David Bruton, M.D., Secretary

April 25, 2000

The Honorable Ralph Campbell, Jr., State Auditor
Office of the State Auditor
300 N. Salisbury Street
Raleigh, North Carolina 27611

Dear Mr. Campbell:

We have reviewed your report on the findings and recommendations that resulted from your review of the Department of Health and Human Services-retroactive Thomas S payments made by the Division of Mental Health, Developmental Disabilities, and Substance Abuse Services for the State Fiscal Year ended June 30, 1999. The following represents our responses and corrective action plan to the Findings and Recommendations.

FINDINGS AND RECOMMENDATIONS FOR FYE 6/30/99

1. RATE SETTING PROCEDURES AND THE RETROACTIVE RATES

Recommendation: "Rate setting is an accounting function that should be the responsibility of the DHHS Controller's Office. The Controller's Office should perform annual cost analysis and budget reviews of the area programs. Based on this data, the Controller's Office should set the rates for Thomas S services. This change will strengthen internal controls and increase separation of duties. DHHS has already taken steps to implement this recommendation."

Response:

The Department agrees with the recommendation that rate setting should be transferred from the Division of Mental Health, Developmental Disabilities and Substance Abuse Services to the Department's Controller's Office.

The Department is in the process of transferring the rate setting authority to the DHHS Controller's Office. This will require two solutions: a short-term solution and a long-term solution. The short-term solution has been implemented. The DHHS Controller's Office is currently working with the Division to set rates based on either a current contract or on a rate that is within a reasonable range. Requests for rate increases must be accompanied by a certification from the area program that they have sufficient funds within their current allocation to support the increase, or that they need additional funds. In either case, documentation to support the rate increase is reviewed in detail prior to implementation.

A "mini" Cost Finding of certain Thomas S rates impacted by the rate adjustment was done by the DHHS Controller's Office and is currently being reviewed. This review should be completed within the next week or two. Appropriate rate adjustments will be made based on the results of this mini cost finding.

For the long-term solution the DHHS Controller's Office will take full responsibility for the rate setting process. Each Thomas S service will be incorporated into the overall Area Program Cost Finding Process. The first year that Thomas S can be included in the full Cost Finding process will be the 2001 fiscal year due to changes some Local Area Programs will need to make to its accounting system's chart of accounts to record expenditures to the detail level necessary to generate the detail needed to set rates.

2. FINANCIAL IMPACT OF THE RETROACTIVE RESIDENTIAL RATE INCREASE

***Recommendation*:** "DHHS Internal Audit should perform a review of the "Tentative Settlement Reports" as soon as possible after the March 31, 2000 submission date to determine the exact dollar impact of the residential rate increase on area programs and their service providers. Additionally, DHHS should review its budgeting procedures to assure that all divisions are in compliance with State budgetary policies."

***Response*:** The Department agrees with the concept of the recommendation; however, we are not sure the desired results can be achieved through a review of the TSR. We will have the Internal Auditor schedule a sample review of the TSR as soon as possible. If, based on this sample review, it is determined additional information is needed to determine the impact of the rate increase on the service providers, we will request the Internal Auditor to field visit some of the providers to obtain the necessary information.

We appreciate the assistance and professionalism provided by your staff in the performance of this audit. If you have questions or need additional information, please contact Sarah Moore at (919) 715-8960.

Sincerely,

H. David Bruton, M.D.

HDB:sbm

cc: Assist. Secretary for Budget and Management
Director, DHHS Office of Internal Auditor
Director, DMH/DD/SAS
DHHS Controller
Director, Division of Budget Planning and Analysis
Office of State Controller