



COMMONWEALTH OF PENNSYLVANIA
DEPARTMENT OF PUBLIC WELFARE
BUREAU OF FINANCIAL OPERATIONS
ROOM 525 HEALTH & WELFARE BUILDING
HARRISBURG, PA 17105-2675

KEVIN M. FRIEL
DIRECTOR

MAY 28 2009

TELEPHONE
(717) 772-2231
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Mr. Gregory Zappala, Chief Executive Officer
Western PA Child Care, LLC
12 Dakota Drive
Emlenton, Pennsylvania 16373

Dear Mr. Zappala:

Enclosed is the final review report of your Agency recently completed by this office. Your Agency's response has been incorporated into the final report and labeled Appendix A. While the Exhibits portion of Appendix A has been included in all other transmittals of this report, it has not been included in your copy due to its volume and because it originated with you.

The final report will be forwarded to the Department's Office of Children, Youth and Families to begin the Department's resolution process concerning the report contents. The staff from that office may be in contact with you to follow up on the corrective action actually taken to comply with the report's recommendations.

I would like to express my appreciation for the courtesy and cooperation extended to the DAR staff during the course of the fieldwork.

If you have any questions concerning this matter, please contact Michael Kiely, Audit Manager of the Western Field Office, at (412) 565-2187.

Sincerely,

A handwritten signature in cursive script that reads "Kevin M. Friel".

Kevin M. Friel

Enclosure

c: Mr. Richard Gold

bc: Mr. Crofcheck
WFO File (#W7004)



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MAY 28 2009

Mr. Frank J. Castano, Director
Luzerne County Children and Youth Services
Suite 110
111 N. Pennsylvania Boulevard
Wilkes-Barre, Pennsylvania 18701-3697

Dear Mr. Castano:

Enclosed is the final review report of Western PA Child Care, LLC recently completed by this office. Your Program's response has been incorporated into the final report and labeled Appendix B.

The final report will be forwarded to the Department's Office of Children, Youth and Families to begin the Department's resolution process concerning the report contents. The staff from that office may be in contact with you to follow up on the corrective action actually taken to comply with the report's recommendations.

If you have any questions concerning this matter, please contact Michael Kiely, Audit Manager of the Western Field Office, at (412) 565-2187.

Sincerely,

A handwritten signature in cursive script that reads "Kevin M. Friel".

Kevin M. Friel

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MAY 28 2009

Mr. Richard Gold, Deputy Secretary
 Office of Children, Youth, and Families
 131 Health and Welfare Building
 Harrisburg, Pennsylvania 17120

Dear Mr. Gold:

The Bureau of Financial Operations (BFO) has conducted an audit of Western PA Child Care, LLC (WPACC) for the period July 1, 2007 through June 30, 2008. During this period, WPACC provided secure treatment, shelter and intensive open residential treatment (IORT) services to juveniles referred from various Counties.

Western PA Child Care Executive Summary

ISSUE	SUMMARY
<p>Issue No. 1 – WPACC Expenses Included \$1,267,398 of Questioned Costs.</p>	<p>Questioned costs included:</p> <ul style="list-style-type: none"> • \$533,125 in unsupported administrative fees paid to the principals of WPACC. • \$202,746 in payments to related parties for management services, rent, office expenses, legal expense, marketing and employee background searches. • Costs associated with meals, travel, and staff vehicles that were not adequately supported with appropriate documentation.

ISSUE	SUMMARY
<p>Issue No. 1 (cont) – WPACC Expenses Included \$1,267,398 of Questioned Costs.</p>	<p>Questioned costs included:</p> <ul style="list-style-type: none"> • Reimbursement for golf outings and donations • \$64,686 in mortgage interest paid on construction loan funds paid to companies owned, or controlled by WPACC principals as consulting fees. • \$51,482 in interest paid on a line of credit, while WPACC principals received interest free loans and draws on company funds either directly or through their related companies. • The Department also observed a minimum of \$84,000 in questionable prior period costs, during the conversion of calendar to fiscal year data. The BFO did not test cost data to determine if other questionable costs were incurred in the prior period. The costs identified included costs for a custom made suit for a partner in a related party company (\$3,500), limousine service to the NCAA basketball tournament and a trip to the King of Prussia mall (\$5,800), a chartered fishing trip in Florida (\$4,500), golf outings, charitable contributions and numerous payments to related parties (\$61,380). See Attachment A for examples.

HIGHLIGHTS OF RECOMMENDATIONS
<p>The OCYF should remove the questioned costs from consideration when computing rates eligible for DPW participation. This would result in changes to the daily rates for secure treatment from \$314 to \$249.84, for IORT from \$255 to \$194.81 and for shelter from \$210 to \$205.44. As these rates do not consider any profit, the OCYF must also determine a reasonable profit factor as well.</p>

ISSUE	SUMMARY
<p>Issue No. 2 – WPACC Made Numerous Billing Errors and Did Not Maintain All Required Court Documents. Luzerne County paid for Empty Beds</p>	<ul style="list-style-type: none"> • County Children and Youth Programs (Counties) were billed for both the day of admission and day of discharge. • Counties were erroneously billed for the wrong WPACC treatment program. • Court orders required for admission, transfer and discharge were missing or incomplete. • Luzerne County contracted with WPACC to reserve nine Shelter program beds. As a result the county paid for 679 unused bed days at a cost of \$142,590.

HIGHLIGHTS OF RECOMMENDATIONS
<p>WPACC should:</p> <ul style="list-style-type: none"> • Cease the practice of billing counties for a child's day of discharge • Provide additional training to billing staff on all rules, regulations and contract requirements pertinent to their duties. • Require and maintain court orders for all admissions, transfers and discharges and assure they are complete and accurate. <p>Luzerne County should: Evaluate and make changes to the contract practices and its decision to reserve emergency shelter beds in a facility that is more than 260 miles away from the County seat.</p>

ISSUE	SUMMARY
<p><i>Issue No. 3 – Lack of Adequate Documentation Resulted in Internal Control Weaknesses</i></p>	<ul style="list-style-type: none"> • Vendor invoices and upper management travel reimbursement requests did not have written approval. • Approximately \$2.2 million in interest free loans were made to various companies in which the owners of WPACC have an interest. None of these loans had any formal written documentation. • Paid vendor invoices were not coded so as to identify where they were charged. • Most of the journal entries lacked a description sufficient enough to identify the purpose of the entry.

HIGHLIGHTS OF RECOMMENDATIONS
<p>WPACC Should:</p> <ul style="list-style-type: none"> • Require written approval for payment of all vendor invoices and upper management travel reimbursement • Require written documentation of all provisions of loans to companies in which the owners of WPACC have an interest. • Assure all paid vendor invoices contain coding to identify the cost center and account to which they are charged. • Assure journal entries contain a sufficient description of the entry's purpose.

Western PA Child Care, LLC
July 1 2007 to June 30 2008

ISSUE	SUMMARY
<p>Issue No. 4 – WPACC Did Not Adequately Allocate Costs Between Its Three Programs</p>	<ul style="list-style-type: none"> • Costs that could have been separately identified as either Shelter or IORT were combined in one cost center. • Costs for doctor visits and x-rays that should have been charged directly to the Shelter and Secure programs were instead allocated between the programs. • Percentages used to allocate overhead costs to the three programs were incorrect.

HIGHLIGHTS OF RECOMMENDATIONS
<p>WPACC should:</p> <ul style="list-style-type: none"> • Maintain separate cost centers for all programs • Charge costs directly whenever possible • Allocate costs based on criteria that reflect each cost center's usage such as square footage, employees in a department, etc.

OBSERVATION	SUMMARY
<p>Observation No. 1 – WPACC Principals withdrew \$1 million of construction loan proceeds as consulting fees.</p>	<p>WPACC Principals withdrew \$1 million of construction loan proceeds as consulting fees paid to their respective related companies. WPACC provided no documentation of any services provided for these fees.</p>

OBSERVATION	SUMMARY
<p>Observation No. 2 – Inefficient cash management resulted in lost interest income, unnecessary interest expense, late payment fees and utility shut-off notices</p>	<p>Loans to related companies and individuals were significant enough that available cash reserves were not sufficient to ensure that the facility could continue to pay vendor bills. The depletion of cash reserves resulted in late fees and utility shut-off notices and created a need to borrow money and incur interest expense.</p>

Background

Western PA Child Care (WPACC) is a for-profit Pennsylvania limited liability corporation which owns a juvenile residential treatment center located at 13 Dakota Drive in Allegheny Township, Butler County. WPACC was formed in June 2003 by two individuals; a Luzerne County attorney and an investment banker from Allegheny County, after their development and operation of a similar facility; PA Child Care, LLC, in Luzerne County. WPACC began operations in July 2005.

The facility was initially licensed for 48 secure treatment beds and 26 beds for shelter services and/or intensive open residential treatment (IORT). A subsequent addition to the building resulted in increasing the licensed capacity of secure treatment to 60 beds as of January 1, 2008. However, WPACC did not begin to utilize the additional beds until July 2008. Also, the combined shelter/IORT licensed capacity was increased to 39 beds effective July 1, 2008.

WPACC entered into an agreement in June 2005 with Mid-Atlantic Youth Services (MAYS), a Pennsylvania for-profit corporation located in Pittston, Luzerne County, to manage and operate the facility. A revised 36-month agreement with MAYS went into effect January 1, 2007. The agreement places the responsibility of keeping the facility at or near capacity with MAYS and states that the compensation to MAYS is dependant on maintaining a high occupancy level, although no specific rate was indicated in the agreement.

MAYS has two separate reportable segments; Mays-Butler, which maintains a separate general ledger (G/L) to account for costs related to the management and operations of WPACC, and Mays-Luzerne whose G/L captures similar costs applicable to PA Child Care. MAYS also maintains a separate G/L (MAYS-Corp) to record various shared costs that are then allocated to MAYS-Butler and MAYS-Luzerne.

MAYS was incorporated in 2005 by a sole stockholder and CEO. Stock options were available to the principals of WPACC. In May of 2008 one of WPACC's principals purchased and exercised all of the stock options in MAYS and bought out the original shareholder, thereby taking over control of MAYS. This individual also bought out the other principal's ownership interest in WPACC and PA Child Care. As of the start of our fieldwork, one individual owned WPACC, PA Child Care and all of the issued shares of MAYS. As of the close of our fieldwork, negotiations on a severance package for the original shareholder and former CEO of MAYS were still in process.

Objectives, Scope and Methodology

Our objective was to determine the actual cost of service to residents and determine if the costs were reasonable and consistent with applicable cost principles.

Government auditing standards require that we obtain an understanding of management controls that are relevant to the audit objective described above. The applicable controls were examined to the extent necessary to provide reasonable assurance of the effectiveness of these controls. Based on our understanding of the controls, no material deficiencies came to our attention. Areas where we noted an opportunity for improvement in management controls are addressed in the findings of this report.

Our review was conducted between July 21 and December 11, 2008.

In pursuing our objectives, we reviewed available fiscal/accounting records, audits, contracts, payroll data, census reports, client data, invoices, and billings submitted to the County programs. We also reviewed WPACC, MAYS-Butler and MAYS-Corporate operations for compliance with County contracts, DPW regulations and other applicable cost standards. Our work was conducted in accordance with generally accepted government auditing standards. This report, when presented in its final form, is available for public inspection.

Results of Fieldwork

Issue No. 1 - WPACC Expenses Included \$1,267,398 of Questioned Costs

The objective of the audit was to determine the actual cost of service and determine if costs were reasonable and consistent with the PA Code Title 55, Chapter 3170 *Allowable Costs and Procedures for County Children and Youth Social Service Programs* and other applicable cost standards. The BFO identified various questionable costs due to the following reasons:

- Payments to related parties not based on actual costs incurred by the related party;
- Lack of written leases and contracts in place during the audit period;
- Lack of adequate documentation; and
- Costs not necessary or related to facility operations

The costs for WPACC include an allocation of various shared costs assigned, apportioned or allocated from MAYS-Corporate G/L. WPACC costs related to staffing and other operating expenses are recorded in the Mays-Butler G/L. These costs are then included with WPACC's direct costs, primarily related to the building, to arrive at the total costs applicable to the care of WPACC's residents. WPACC, MAYS-Butler and MAYS-Corp accounting records are maintained on a calendar year basis. Therefore, we analyzed each account of the three G/Ls in order to adjust the calendar year balances to the FY07/08 period. Total fiscal year allowable WPACC costs were then allocated or assigned to the three services that receive DPW funding: Secure Residential, IORT and Shelter Care.

To determine WPACC's allowable costs we analyzed costs incurred in FY07/08 for reasonableness and eligibility for DPW participation. Since the costs were reported in three separate G/Ls we analyzed applicable costs recorded on each of the G/L's. The following questioned costs were identified in MAYS-Corporate, MAYS-Butler and WPACC G/Ls.

1. MAYS-Corporate Questioned Costs

The MAYS-Corporate expenses included costs that are ineligible for DPW participation. We are identifying these costs as questionable and have categorized them as related party transactions, unsupported/undocumented costs, expenses not necessary or related to facility operations, expense reimbursement made to a non-employee and questionable interest expense.

These amounts identified below represent the total amount applicable to MAYS-Corporate. Various portions of these totals were applicable to MAYS-Butler. The amount applicable to MAYS-Butler was then stepped-down to each of WPACC's services.

A. Related Party Transactions - \$100,671.85

As discussed in the background section of this report, documents on file at the PA Department of State indicate that MAYS was established with a sole shareholder. The individual listed as the sole shareholder was also the Chief Executive Officer (CEO) until May 2008.

The Stockholders Equity section of MAYS consolidated independent audit report balance sheet, as of December 31, 2006, indicates that of the 100,000 shares authorized, only 500 shares were issued and outstanding. The Current Asset section also reflects a corresponding Stock Subscription Receivable. Discussion with MAYS Chief Financial Officer (CFO) revealed that this receivable (and related shares of stock) reflected the former CEO and sole shareholder's investment in the corporation. The CFO also explained that the two principal owners of WPACC held options to purchase equal amounts of the remaining authorized shares of MAYS at any time. By virtue of the stock options agreement, which represented 99.5% of the authorized shares, the principals of WPACC had the ability to exercise significant control over the operations of MAYS and therefore meet the definition of related parties.

To be considered reasonable, transactions between related parties need to be necessary, limited to actual costs, and less than or equal to the amount a non-related party would pay for the same or comparable goods or services. Documentation such as competitive bids should be obtained and maintained to support the reasonableness of related party charges.

Western PA Child Care, LLC
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Based on our review of transactions recorded on MAYS-Corp general ledger we identified the following related party questionable costs recorded during the FY07/08 period:

1. The Powell Law Group, P.C. - Management Fee \$65,000.00
Office Expense \$ 3,557.37

One of the principal owners of WPACC is also a principal and president of The Powell Law Group, P.C. (PLG).

WPACC paid PLG a management fee which, according to the MAYS CFO, represented reimbursement for accounting services performed on behalf of MAYS by a full-time employee (and Treasurer) of PLG. The payment was purported to reflect time and activity that the PLG employee spent working on MAYS related activity. However, no formal written agreement existed to document this relationship and no detail of the number of hours, hourly rate, etc., was provided to support these payments.

Office Expenses paid to PLG were supported by invoices that indicated they were additional charges to MAYS for photocopies, faxes, postage, Fed Ex fees and telephone expenses incurred on specific dates, presumably on behalf of MAYS. However, insufficient detail was provided to support that these were legitimate expenses related to MAYS.

2. Big Kahuna Realty, LLC - Rent \$8,600.00

The PA Department of State business entity filing history lists a principal of WPACC as the president of this limited liability company.

According to the MAYS CFO, these costs represented reimbursement to Big Kahuna, which is related to PLG through common ownership, for a portion of the office space occupied by the PLG employee who performed accounting services for MAYS. There was no lease or any other documentation to support this cost or the reasonableness of the amount charged. Further, MAYS had sufficient space for this individual at its offices.

3. Gladstone Partners, LP - Legal Fees \$20,000.00

According to this entity's web site and various media sources, both of the principal owners of WPACC and another partner were members of this limited partnership during our audit period. This limited partnership is involved in developing an international cargo airport and transportation center in the Hazleton area. The legal fees were supported by two invoices for \$10,000 each that identified Gladstone Partners, LP as the Client and the services provided as government affairs consulting services. No documentation was provided to

support how the cost was related under applicable regulations of allowable cost for facility operations.

4. Legal Eye Productions, LLC - Marketing/Public Relations \$3,264.48

The president of PLG, who is also one of the principal owners of WPACC, is listed as the president of this limited liability company. According to Legal Eye Productions web site (<http://legaleyellc.com>), they specialize in creating effective communication tools for the legal community. Invoices supporting these costs indicated the services performed included design and development of brochures and postcards, DVD duplication & postage, and Web updates. They did not however provide documentation to support the amount invoiced.

5. Virtual Legal Assistant, LLC - Marketing/Public Relations \$250.00

According to the Virtual Legal Assistant web site (<http://virtuallegalaid.com>), they perform work of a legal nature under the supervision of an attorney.

We consider Virtual Legal Assistant, LLC a related party because the president of this LLC is an employee of PLG which as addressed previously is related to WPACC. Also, the secretary and treasurer of Virtual Legal Assistant is the same former PLG employee who performed accounting services for MAYS, was MAYS acting CEO and is now a consultant to MAYS.

The invoice from this vendor contained a charge for "Travel and Presentation Charges – PPoint Design" with the charge appearing to be for two hours at \$125.00/hour. The invoiced rate coincides with the web sites fee schedule for Trial Preparation and Presentation – Exhibit Presentation Preparation (utilizing "Sanctions" and "Powerpoint"), however, the MAYS invoice does not indicate how this service is necessary or related to facility operations.

B. Unsupported Costs - \$90,356.23

During our review of MAYS-Corporate accounts we were unable to verify the following expenses to source documents and receipts: Automobile Expense for the CEO and numerous entries in the Office Expense, Meals and Travel Accounts. In addition, we identified travel, meal, and other expense that were not supported as being necessary or related to facility operations.

A summary of these unsupported costs, incurred during FY 07/08, are as follows:

1. Automobile for CEO - \$10,020.00

The CEO drove a vehicle provided to him by MAYS. Maintenance on the vehicle was paid for by MAYS. For six months during our audit period the CEO received monthly checks for automobile expenses in the amount of \$1,670.00 for a total of

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\$10,020.00. According to the owner of WPACC and MAYS the CEO was given a monthly amount so that he could obtain whatever car he wanted and MAYS wouldn't need to be concerned if he used it for his other business. Because these payments did not reflect actual costs incurred by the CEO, these costs are considered unsupported expenses.

2. <u>Lack of Supporting Documentation of Costs</u> - Office Expense	\$14,735.73
Meals	1,569.70
Travel	10,068.56
Travel & Entertainment	9,768.91
Entertainment	37,569.21

WPACC was not able to provide documentation to tie adjusting journal entries for office expense of \$12,015.82, travel & entertainment of \$9,238.79 and entertainment expense of \$35,269.21 charged by MAYS-Corporate back to the original receipts. Therefore the total of these adjusting journal entries has been included in the questioned costs.

Also, WPACC was not able to provide documentation to support additional office expense of \$2,719.91, meal expense of \$1,569.70 and travel expense of \$10,068.56 reflected as charges on credit card monthly statements. MAYS did not provide receipts or other documentation to support that the charges were necessary or related to facility operations.

Additionally, no supporting documentation was on file to support entertainment expense reimbursements of \$1,800 to MAYS former CEO and \$500 to one of WPACC's principals. Also, no documentation could be located for a \$530.12 reimbursement to a WPACC employee that was expensed to the travel & entertainment account.

3. <u>Costs Not Necessary or Related to Facility Operations</u> -	Travel	\$2,867.70
	Marketing/PR	2,463.86
	Dues&Subs.	380.00
	Entertainment	312.00
	Compensation	308.62
	Meals	291.94

The Marketing Director of MAYS was reimbursed a total of \$62.97 for golf outings and related mileage that was recorded as travel expense. In addition, MAYS-Corporate marketing/public relations expense included \$710 of costs related to golf outings and sponsorship. These costs are questioned because they are not necessary or related to facility operations.

As previously stated in the Related Party section of this report, a full-time employee and Treasurer of PLG performed accounting work for MAYS. During this time, this employee requested reimbursement of \$291.94 for Meals, \$2,804.73 for Travel and \$125 expensed as marketing/public relations, and \$25 entertainment expense related to political fundraisers. Also, \$380 was paid by Mays-Corporate for two years of his

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membership dues for a private dining club located in Philadelphia. This amount was recorded as dues and subscriptions expense. There was no formal written agreement to document what costs of this individual if any were the responsibility of MAYS.

Because he was not an employee of MAYS, these costs are not the responsibility of MAYS.

Other costs not necessary or related to facility operations that we identified included a \$250 donation to Men of Marian and \$1,378.86 of promotional items such as golf towels and tees, shirts, umbrellas, visors and pens expensed to marketing/public relations, and \$287 for Pittsburgh Steelers football game tickets charged as entertainment expense.

MAYS-Corporate compensation expense also included a \$308.62 payment directly related to PA Child Care. This amount was adjusted out of the MAYS-Corporate books so that a portion of cost was not allocated to MAYS-Butler.

C. <u>Interest Costs:</u>	Loan Interest expense	\$51,482.23
	Liability Insurance expense	\$ 3,150.29
	Automobile Insurance expense	\$ 1,010.94

MAYS maintained a \$750,000 line of credit with S&T Bank. During our audit period, the monthly outstanding balance of this debt remained constant at \$749,750 after payment of interest. Only interest payments, totaling \$51,482.23, were made on the line of credit during the FY07/08 period.

We also identified interest costs in the liability and automobile insurance expense accounts. This interest expense was incurred as a result of MAYS financing annual liability and automobile insurance premiums. Insurance financing interest expense for the FY07/08 period was \$3,150.29 for the liability premium and \$1,010.94 for the automobile policy premium.

We question the reasonableness and necessity of MAYS incurring these costs and allocating a portion to WPACC. Based on the volume of informal, interest free loans to related parties, draws by the sole shareholder of MAYS, and similar interest free loans made by WPACC to related parties and one of its principals, along with draws taken by WPACC's two principal owners (See Observation No. 2), the amount of these discretionary cash outflows far exceeded the line of credit and insurance premiums financed by MAYS-Corporation.

MAYS-Corporate Summary

The total questioned costs for MAYS-Corporate are \$246,671.54. We reduced MAYS-Corporate FY07/08 G/L trial balance by this amount on a line by line basis to arrive at total MAYS-Corporate allowable costs. The allowable costs were then assigned, allocated or apportioned to MAYS-Luzerne and MAYS-Butler based on various

allocation methodologies. The total allowable MAYS-Corporate costs allocated to MAYS-Butler was \$286,325.27.

2. MAYS-Butler Questioned Costs

MAYS-Butler is the segment of MAYS-Corporation that provides management services to WPACC. Our review of MAYS-Butler expenses identified questionable costs that we categorized as related party transactions, unsupported/undocumented costs and expenses that were not necessary or related to facility operations. These costs are as follows:

A. Related Party Transactions - \$20,075

Marsicano Law Investigations (MLI)

As stated in the Related Party section of the MAYS-Corporate questioned costs we identified Gladstone Partners, LP as a related party. According to Gladstone's web site and various media sources, a third partner, who is the principal owner of MLI, and the two principal owners of WPACC were members of Gladstone during our audit period. By virtue of the Gladstone relationship we considered MLI to also be a related party.

During our audit period a total of \$20,075 was billed to MAYS-Butler for background searches conducted by MLI. This amount included a \$350 monthly fee and a charge of \$75 per each background search. There was no formal agreement to support the amounts billed, nor any documentation to show that a competitive bidding process was performed to support the reasonableness of these charges. Furthermore, our review of a sample of background searches submitted by MLI indicated that most of the information provided duplicated the information provided by required Act 33/34 Clearances.

B. Unsupported Costs - \$565,442.06

1. Management Fee - \$552,500

During the FY07/08 period we identified a total of \$552,500 of management fee expense. The MAYS CFO indicated that the fee was a budgeted charge and did not represent actual cost. Furthermore, no documentation or explanation was provided to attempt to support the reasonableness of these charges. Therefore we classified the entire management fee expense as questioned costs.

2. Rent - \$6,000

A single adjusting journal entry in the amount of \$6,000 was posted to the rent expense account on July 31, 2007. According to the general ledger reference, the credit half of the entry was posted as due to MAYS-Corp. Since MAYS-Butler is a segment of

MAYS-Corp and no lease, rental agreement or other documentation was provided to support this expense as an actual cost we classified this amount as questioned costs.

3. Depreciation Expense - \$6,942.06

MAYS-Butler was unable to provide a depreciation schedule to support the \$6,942.06 in depreciation expense recorded on their G/L. Our review of MAYS-Corporate depreciation schedules identified various assets as assigned to MAYS-Butler and MAYS-Luzerne. Due to lack of supporting documentation and since MAYS-Butler assets are reflected on MAYS-Corporate depreciation schedules we questioned the depreciation expense recorded on the MAYS-Butler G/L.

C. Costs Not Necessary or Related to Facility Operations - \$1,820

During our audit period \$1,320 was expensed on golf outings and another \$500 posted to the Donations expense account as a charitable donation to the March of Dimes. Neither expense is necessary or related to facility operations.

MAYS-Butler Summary

MAYS-Butler's total questioned costs of \$587,337.06 are included in WPACC's questioned costs. The total allowable costs for MAYS-Butler, which include the allowable costs from MAYS-Corporate, are allocated across each of the three programs in WPACC. Each of these allocated costs is then included in WPACC's allowable costs under the respective program which they represent.

3. WPACC Questioned Costs

Our review of costs charged directly to WPACC identified the following questioned costs.

A. Related Party Transactions - \$82,000

1. Management Fees - \$70,000

A total of \$70,000 was paid to reimburse PLG for accounting work that PLG's treasurer performed for WPACC. There was no contract documenting services required by WPACC nor were there invoices submitted to document services actually provided.

2. Rent - \$12,000

As stated in the Related Party section of this report, a principal of WPACC is also listed as the president of Big Kahuna Realty, LLC.

According to the MAYS CFO, the \$12,000 cost represented reimbursement to Big Kahuna, which is a related company of PLG, for a portion of the office space occupied

by the PLG employee who performed accounting services for MAYS and WPACC. No documentation was provided to support this cost or the reasonableness of the amount charged. Further, MAYS had sufficient space for this individual at its offices.

B. Unsupported Costs - \$533,375

On December 31, 2007 a single adjusting journal entry was posted to the Administrative Fees expense account for \$533,125. The credit side of this journal entry was \$266,562.50 to offset A/R- Loans to RJP (one of the principals) and \$266,562.50 to A/P- Other. According to the MAYS CFO this entry represents payments to WPACC principals. He indicated that the entry was an error and should not have been made at all.

Also, a charitable donation to the Men of Marian was made in the amount of \$250. Charitable contributions are unallowable.

C. Mortgage Interest Expense - \$64,686

Our review identified FY 07/08 mortgage interest expense of \$905,967 related to WPACC's \$14 million construction/mortgage loan.

As explained in Observation No. 1, \$1 Million from the proceeds of this loan were paid as fees to companies owned and or controlled by WPACC's principals. WPACC provided no documentation of any services provided for these fees. At our closing conference, WPACC management explained these as consulting fees for developing the property. As the owners of the property, the principals' equity increases as the debt decreases. Additionally, the principals can benefit, over time, by any appreciation in the value of the property. Since these payments could not be adequately supported we added mortgage interest expense of \$64,686 related to the \$1 million in fees to the questioned costs.

Recommendations

The BFO recommends that the Office of Children, Youth and Families consider the above questioned costs as not being consistent with applicable cost standards and exclude the net effect to WPACC of \$1,267,398 from WPACC's FY adjusted costs of \$7,400,617 to arrive at FY07/08 audited costs of \$6,138,469. Based on our audited, actual units of service provided (See: Issue No.2) we computed per diem rates, without consideration of any profit factor, of \$249.84 for secure treatment, \$194.81 for IORT and \$205.44 for Shelter.

While we recognize that a number of the questioned costs are the types of costs a provider of service could incur, OCYF must determine the reasonableness of those costs moving forward, as well as an agreed upon and reasonable profit.

Issue No. 2 – WPACC Made Numerous Billing Errors, Did Not Maintain All Required Court Documents and Billed Luzerne County for Reserving Empty Beds

In order to compute per diem rates for each type of service based on our audited costs we reviewed WPACC's computerized census database and hardcopies of county billings for the FY07/08 period to determine the actual units of service provided. We also tested a sample of billings by tracing back to the authorizing court orders and reviewed county contracts for compliance. The following concerns were noted:

A. Billing Errors

Our comparison of units of service billed to census records indicated that WPACC routinely billed for service provided on the day of discharge, if the discharge occurred after 12:00 pm. This methodology is not consistent with the standard county contract payment provisions which specify that payment shall be made for the first and all subsequent days of care **excluding the day of discharge** (emphasis added). The effect of incorrectly billing the day of discharge resulted in a decrease of 8 Secure Treatment, 6 IORT and 18 Shelter units of service.

We also noted two instances where Luzerne County was billed for 8 days of Shelter that should have been billed as Secure Treatment and was billed for 4 days for Shelter when the child was not at the facility according to census and discharge records. The net effect of these discrepancies increases the Secure Treatment census by 8 days and decreases the Shelter program by twelve days.

Finally, we discovered that several Erie and Philadelphia County clients were billed to the wrong program when transferred from one program to another within WPACC. The net effect resulted in an increase of 5 Secure Treatment units, an increase to the IORT program of 4 days, and a decrease to the Shelter program of 9 days.

The net effect of the above billing errors was to increase actual, allowable Secure Residential units of service by five days to 17,566; reduce IORT by 2 days to 4,745; and reduce Shelter days by 39 to 4,018.

B. Court Orders

To verify accuracy of billings we traced a sample of billings back to the court order that authorized the service. We were unable to locate some of the court orders for the admission into WPACC and transfers between programs within the facility. Also, many of the court orders for discharges were missing. Title 55 Section 3800.243 paragraph 10 states that each child's record shall include their court orders (if applicable). Without a court order it is not possible to determine when the child should have been admitted, transferred or discharged from a program or the facility. Based on discussions with staff it was learned that court orders were not consistently maintained in one location. Some of the sampled court orders were later located in a central file, while others were in

Western PA Child Care, LLC
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individual children's files. We were also informed that WPACC policy does not require retention of discharge orders.

Another concern we noted was that court orders from the juvenile justice system do not always clearly identify WPACC as the facility of admission or discharge. Our review found orders identifying the facility committed to or released from as "Western PA Shelter Care" or "MAYS", etc. While this is not the fault of WPACC, they should work with the Counties to ensure that court orders specify Western PA Child Care Shelter Facility or Western PA Child Care Secure Treatment Facility.

C. Luzerne County Placement Agreement

WPACC entered into a placement agreement with Luzerne County and the Court of Common Pleas of Luzerne County on July 1, 2007.

A clause in the general provisions of the contract states:

"The County hereby secures the right to utilize (9) beds for Shelter Care at the Facility, at the rates set forth in Article X, commencing July 1, 2006. The Owner agrees to secure and reserve nine (9) beds on a full-time basis for the County in Shelter Care at the Facility, subject to the provision of Paragraph V. herein."

Our review of Luzerne County monthly billings indicated that WPACC, in accordance with the Luzerne contract, billed the county for unfilled, available Shelter beds, up to a maximum of 9 each day at the regular Shelter rate of \$210 per day. For the FY 07/08 period, a total of 679 days of service at a total cost of \$142,590 were billed to and paid by Luzerne County for these reserve bed days even though no actual Shelter services were provided.

Recommendation

The BFO recommends that WPACC billing staff be made aware of all pertinent contract payment provisions to ensure that county billings are accurate and in compliance with contract terms.

The BFO also recommends that accurate census records be maintained and compared to billings to ensure accuracy of amounts billed.

The BFO further recommends that WPACC ensure that court orders are received and maintained in a central location to support all admissions, transfers between programs and discharges of juveniles served at the facility.

The BFO finally recommends Luzerne County evaluate and make changes to the contract practices that resulted in the payment for empty beds and the reservation of emergency shelter beds in a facility that is more than 260 miles away from the County seat.

Issue No. 3 – Lack of Adequate Documentation Resulted in Internal Control Weaknesses

During the course of our audit of WPACC, we noted the following internal control weaknesses:

Lack of Payment Authorization

No written authorization or approval was indicated on vendor invoices or upper management travel expense forms prior to payment. Lack of a structured payment approval process could allow payments to be processed without proper authorization.

Lack of Formal Loan Agreements

A number of interest free inter-company loans were made between WPACC, MAYS-Corporate and various companies in which the owners of WPACC have an interest. None of these loans had any formal documentation to state that a loan existed. The only indication that these loans existed were the balance sheet accounts and related entries. Written agreements should be prepared and maintained to support all loans.

Account Coding

A majority of MAYS-Corporate paid invoices were not coded to identify the cost center and expense account to which they should be charged. Account coding should be present on all paid invoices to provide a proper audit trail and assure posting to the correct expense account.

Lack of Explanation of Journal Entries

Our review of the MAYS-Corporate and WPACC general ledgers found that in most cases entries to the general journal lacked sufficient information describing the purpose of the entry. As a result it was often not possible to determine the appropriateness of the entry.

Recommendations

The BFO recommends that a formal payment authorization process be developed. The BFO also recommends that any inter-company loans be supported with formal loan documentation. The BFO further recommends that account coding be written on paid invoices. The BFO finally recommends that an explanation be included with all journal entries indicating where funds are going to or coming from or if split between different accounts what the split/methodology was.

Issue No. 4 – WPACC Did Not Adequately Allocate Costs Among Its Three Programs

WPACC did not maintain separate cost centers on its accounting system for the shelter and IORT programs. For accounting purposes the Shelter and IORT programs were combined into one cost category, listed as Shelter. The Shelter and IORT programs should be separated to allow for tracking of actual costs and proper allocation of overhead costs.

In the case of doctor visits and x-rays, costs that could be directly charged to the Shelter and Secure programs were instead split between the two. Costs that can be identified to a specific program should be charged directly to that program.

The percentages used to allocate overhead costs to the individual cost areas were incorrect. The allocation percentage used for Secure was 67%. The allocation percentage used for Shelter and IORT was 33%. For the purpose of our review we separated overhead costs into multiple categories and allocated the costs based on the most logical base possible, i.e., utilities were allocated based on square footage, Professional Fees are allocated based the number of employees in each department, etc.

Recommendation

The BFO recommends that WPACC and MAYS-Butler segregate costs between the Shelter and IORT programs. The BFO further recommends that costs that are directly assignable to a specific program be assigned to that program. The BFO finally recommends that the percentages used to allocate overhead costs be based on equitable methodologies.

Observation No. 1 – WPACC Principals Withdrew \$1 Million of Construction Loan Proceeds as Consulting Fees Paid to Their Respective Related Companies

In June 2004 the principal owners of WPACC obtained a \$14 million construction loan to finance the building, land improvements and some of the equipment for the WPACC facility which was completed in September 2005.

According to WPACC's 2005 independent audit report, the capitalized land, building and land improvements, and furniture and equipment cost was approximately \$12.7 million. In an attempt to reconcile the difference between the loan amount and the cost basis we reviewed the various loan documents and depreciation schedules.

Our review of the construction loan exhibits included a breakdown of the total project costs and amount of the required financing. We noted that the project costs included consulting fees for Vision Holdings, Inc. (\$500,000) and Consulting Innovations & Services, Inc. (\$500,000).

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Other documents related to the loan reflected that one of WPACC's principals signed as a member of Vision Holdings, Inc. and the other principal signed as President of Consulting Innovations & Services, Inc. Also, both of these companies were identified as members of PA Child Care, LLC, a related juvenile detention center located in Luzerne County.

At our closing conference, WPACC management explained the consulting fees as fees for developing the property. WPACC provided no documentation of any services provided for these fees.

Since the principals essentially withdrew \$1 million of the loan proceeds, we reduced the amount required to finance the facility to \$13 million. As noted in Issue No. 1 of this report, we questioned the reasonableness of the portion of mortgage interest expense related to the \$1 million in consulting fees.

Observation No. 2 – Inefficient Cash Management Resulted in Lost Interest Income, Unnecessary Interest Expense, Late Payment Fees and Utility Shut-off Notices

A review of WPACC, Mays-Butler and Mays-Corp un-audited general ledgers for calendar year 2007 and for the period January 1 through June 30, 2008 reflects net income/ (loss) as follows:

	<u>2007</u>	<u>1/1-6/30/08</u>	<u>Total</u>
WPACC	\$1,351,315	\$1,077,910	\$2,429,225
Mays-Butler	(343,268)	(122,893)	(466,161)
Mays-Corp	<u>525,095</u>	<u>(31,244)</u>	<u>493,851</u>
Total	<u>\$1,533,142</u>	<u>\$ 923,773</u>	<u>\$2,456,915</u>

The above schedule clearly shows that WPACC generated significant net income (Profit), to cover Mays-Butler and Mays-Corp losses, even when including all questioned costs discussed in Issue No. 1 of this report. Yet, our review of Mays-Butler expenses revealed that various WPACC vendor invoices were paid after the due dates and late payment fees were assessed. We also noted that WPACC had received disconnection/shut-off notices from their electricity and natural gas suppliers in June 2008 due to overdue account balances, and as discussed in issue No. 1 of this report, MAYS-Corp had an outstanding line of credit balance of \$749,750 on which they paid over \$50,000 of interest expense in FY07/08, as well as over \$4,000 of interest expense to finance annual insurance premiums.

MAYS management explained that they had experienced significant cash flow problems in April through June 2008 and as a result, they were unable to make timely payment on all of WPACC/MAYS bills. They also claimed that cash flow issues necessitated the

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financing of insurance premiums and was the reason they were unable to reduce the line of credit balance.

Considering the un-audited net income figures above, WPACC and MAYS should have had sufficient funds available to meet all of their obligations on a timely basis and been able to reduce or even eliminate existing debt. However, our review of their balance sheet accounts indicate that a significant portion of their net income was used for non-WPACC related purposes.

Our review identified several loans, notes and other transfers of funds to related companies. According to management, no formal loan agreements, notes or other documentation is available to support the purpose or necessity of these transfers as it relates to client care. Furthermore, WPACC/MAYS does not receive any interest income from their related companies for these loans.

The following chart indicates the un-audited balances as of December 31, 2007 and June 30, 2008 of the undocumented, interest-free loans, notes and other transfers of funds reflected as receivables on WPACC and MAYS-Corp balance sheets:

<u>WPACC</u>	<u>As of</u> <u>12/31/07</u>	<u>As of</u> <u>6/30/08</u>
Note Rec. – 40 Degrees N.	\$ 100,000	\$ 100,000
Note Rec. - Gladstone	0	150,000
A/R-Loans to R.J.P.	972,238	1,650,701
Prepaid Airtime- 40 Degrees N.	<u>(1,857)</u>	<u>8,143</u>
TOTAL	<u>\$1,070,381</u>	<u>\$1,908,844</u>
<u>MAYS-Corp.</u>		
Stock Subscription Rec. (J.G.)	\$ 10,000	\$ 10,000
Due from Fishin	107,000	107,000
Due from PLG	15,000	15,000
Due from Legal Eye Prod.	841	841
Prepaid Airtime-40 Degrees N.	140,000	140,000
Note Rec.-Big Kahuna Realty	<u>129,931</u>	<u>20,860</u>
TOTAL	<u>\$ 402,772</u>	<u>\$ 293,701</u>

While these transactions did not directly result in additional expense to WPACC during our audit period they did have a negative impact on the cash flow of both WPACC and MAYS-Corp. and reduced cash available to pay obligations as they came due.

Another reduction of cash reflected on the balance sheets of WPACC and MAYS-Corp is draws on equity made by the principals of WPACC and the initial shareholder of MAYS. The combined cumulative balance of WPACC principals draws as of the June 30, 2008 un-audited G/L was \$678,343 with \$365,343 occurring in FY07/08. MAYS-

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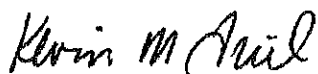
Corp cumulative balance of draws as of June 30, 2008 was \$191,152 with \$41,151 occurring in FY07/08.

Subsequent to completion of our fieldwork, an exit conference was held on March 18, 2009 to discuss the contents of this report with WPACC management. Their response to this report is included as Appendix A. Upon review of the response, an Auditor's Commentary was prepared and included in the report. Additionally, Luzerne County Children and Youth Services provided a response to the recommendations addressed to them in Issue No. 2 of this report. Their response is included as Appendix B.

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

Please contact Alex Matolyak, Audit Resolution section, at (717) 783-7786 if you have any further questions concerning this audit or if we can be of any further assistance in this matter

Sincerely,



Kevin Friel

c. Mr. Gregory Zappalla

bc: Mr. Richard Gold
Mr. Thomas Diehl
Mr. Kevin Friel
Mr. Thomas Crofcheck
Mr. Michael Kiely
WFO (W7004)
File

AUDITOR'S COMMENTARY

Auditor's Commentary

The WPACC response to Issue No. 1 of the draft audit report did not provide sufficient additional information or documentation to support any changes to the total costs determined as allowable. As a result no changes were made to the per diem calculations. Furthermore, a number of documents provided in their response contradicted those they previously provided.

Although not specifically addressed in the narrative, a review of the financial computations provided in the response (Schedule#2, B1) indicates WPACC management's acceptance of a number of the BFO cost adjustments. The pre-profit difference between audited allowable costs identified by BFO and the amount identified by WPACC is \$406,125 (\$6,544,594 vs. \$6,138,469). A reconciliation of this difference identified \$101,254 in calculation errors and incorrect allocations in the WPACC presentation. The remaining \$304,871 represents costs that BFO identified as questionable due to one of the following reasons:

- Payments to related parties not based on actual costs incurred by the related party;
- Lack of written leases and contracts in place during the audit period;
- Lack of adequate documentation; or
- Costs not necessary or related to facility operations.

While we recognize that a number of the costs included in the \$304,871, are the types of costs a provider of service could conceivably incur, OCYF must determine the reasonableness of those costs moving forward, as well as an agreed upon and reasonable profit. The BFO is available to assist the OCYF upon their request.

WPACC's response to Issues 2, 3, and 4 of the draft report indicates that they disagree with each issue. However, our review of their response only identified disagreement with parts of Issues No. 2 and No. 3.

- Issue No.2 A. – Billing Errors, WPACC responded that the 2007-2008 contracts did allow for billing for the day of discharge. Our review of their county contracts however, indicated that only the Butler and Luzerne contracts, which were drafted by WPACC, included this wording. The standard payment provision in all of the other contracts that we reviewed expressly excluded the day of discharge from billable days of service.
- WPACC's response to Issue No. 3 regarding Account Coding indicated that almost all of MAYS-Butler and WPACC invoices were appropriately

coded. While our draft report did not specify which company's paid invoices were missing cost center and expense account coding, the issue was primarily related to MAYS-Corporate paid invoices. Therefore, we revised the wording of the issue to make that clarification.

Finally, WPACC's response related to Attachment A of the draft report stated in part that the "BFO sought out these expenses that were included before the review period in order to incite a scandal in an effort to harass and embarrass the principal of MAYS and WPAACC ...". The executive summary of the audit report, however, clearly explained that the auditors had observed a minimum of \$84,000 of questionable prior period costs during the conversion of calendar to fiscal year data as part of the review, and were obligated to report the finding. In addition, disclosure of these questionable costs was particularly relevant as the practice of funding unallowable personal costs with WPACC revenues was documented to have continued through the audit period.

ATTACHMENT A

WESTERN PA CHILD CARE, L.L.C.

1553

Date	Type	Reference
6/11/2007	Bill	M. Marsicano

Original Amt.	Balance Due	6/20/2007 Discount	Check Amount
2,625.00	2,625.00		

Payment
2,625.00
2,625.00

Checking S & T Ban. M. Marsicano

2,625.00

8208

View this document on 877-866-8775 Order # 48828-1

ETM

INVOICE

702 East Market St
Scranton, Pa 18509
570-344-~~XXXX~~
570-~~XXXX~~

INVOICE # 112
DATE: March 26, 2007

Bill To:
Bob Powell

Comments or special instructions:

Days	DESCRIPTION	AMOUNT
3-23 to 3-25-07	NCAA elite 8 games 31hrs @ 125.00 Fri 12:00pm - 11:00pm Sat 12:00pm - 10:30pm Sun 11:00am - 8:00pm	3875.00
3-23-07	King of Prussia Mall 17.5 @ 110.00	1925.00
		5800.00

Make all checks payable to Event Transportation Management
If you have any questions concerning this invoice, contact 570-344-~~XXXX~~

THANK YOU FOR YOUR BUSINESS!

WPACC 1933
PACC 1934
MNYS 1933 ✓

MID-ATLANTIC YOUTH SERVICES CORP.

Pa Child Care, LLC

Date 3/28/2007
Type Bill
Reference Reimburse expenses

333

Original Amt. 1,933.00
Balance Due 1,933.00
3/28/2007 Discount
Check Amount

Payment 1,933.00
1,933.00

Community Banks - C Reimburse expenses

1,933.00

15372

www.chaseonline.com 800-525-5778 Order # 153265-1

Patrick Owens

From: Robert Arrington
Sent: Wednesday, May 02, 2007 12:24 PM
Subject: Reel Justice

Hey Pat,

Greg Zapalla was in town last week and he fished 3 days, 2 on the Reel Justice and one on a buddy of mine's boat. (Swordfishing) He was here for a week so I hoired the mate for the whole week not knowing exactly when we would fish.

I put the gear we needed on the Reel Justice account at Grand slam. It was like 400 dollars and 200 dollars in fuel. If you charge him 750 for the trip with me swordfishing it will cover all you cost and there is obviously no cost for the boat.

So charge him for 2 days on the Reel Justice and 750 for charges while swordfishing.

I paid the mate 600.00 for the week so I need to get a check from you as soon as possible thanks.

Robert Arrington
Jupiter, Florida 33458

Handwritten notes and calculations:
750
1875
1875
4500.00
7500 each
MAYE
PACC
1500
11500
W/PACC
Posted
5/23/07
Pd
ck# 297
R

You Yahoo!?
Tired of spam? Yahoo! Mail has the best spam protection around
<http://mail.yahoo.com>

WESTERN PA CHILD CARE, L.L.C.

Mid-Atlantic Youth Services - Corp.

Date 5/23/2007
Type Bill
Reference Repay

1552

6/20/2007

Original Amt	1,500.00	Balance Due	1,500.00	Payment	1,500.00
				Discount	
				Check Amount	1,500.00

Checking - S & T Ban - Repay

1,500.00

8009

www.checkbook.com 800-946-6773

Call # 468094-1

APPENDIX A

BRUCKER SCHNEIDER & PORTER

ATTORNEYS AT LAW

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PITTSBURGH, PA 15236

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(412) 261-8036 (fax)

North Hills Office:

1007 Mt. Royal Boulevard
Second Floor
Pittsburgh, PA 15223
(412) 486-2094
(412) 486-2176 (fax)

Reply to: Main Office

March 6, 2009

VIA HAND DELIVERY

Mr. Michael J. Kiely
Division of Audit Review
Bureau of Financial Operations
Department of Public Welfare
701 State Office Building
300 Liberty Avenue
Pittsburgh, PA 15222

Re: Response to WPACC Draft Audit Report dated February 11, 2009

Dear Mr. Kiely:

For any draft audit to be truly beneficial, the parties concerned must have a dialogue designed to resolve open issues or disputes in some meaningful fashion before drawing any conclusions therefrom.

By way of background: by letter dated July 11, 2008, from Richard E. Wessel, CFE, Manager of Western Operations, Bureau of Financial Operations ("BFO"), Department of Public Welfare, to Mr. Michael Cummings, Executive Director of Western PA Child Care, LLC ("WPACC"), which is attached hereto as Exhibit A, Mr. Wessel outlined certain audit procedures in connection with the BFO's audit review of WPACC. Included therein at item 5, Mr. Wessel states: "Draft Report. The draft report is limited in distribution. The purpose of the draft report is to allow those responsible to review the report prior to issuing the final report and also to obtain your written responses." Mr. Thomas Crofcheck was copied on this letter.

Mr. Michael J. Kiely
Division of Audit Review
March 6, 2009
Page two

In contravention of Mr. Wessel's directive that the "draft report is limited in distribution," the draft report was released on February 11, 2009, with great fanfare to the news media before it was delivered to WPACC. Moreover, simultaneous with the release of the draft report to the news media, Mr. Thomas Keating of the Attorney General's Office, faxed a letter to Geoffrey R. Johnson, Esquire, counsel to PA Child Care, LLC ("PACC"), requesting that the litigation filed by PACC against Mr. Crofcheck and Mr. Leonard Pocius (the "Action"), both of the Department of Welfare, be dismissed. The premature disclosure to the media was the initial factor and basis for the original litigation filed by PACC. A copy of the February 11, 2009 letter is attached hereto as Exhibit B.

We could take the position that the events of February 11, 2009, when coupled with the irregular, inappropriate and unfounded statements contained in the "draft audit" of that date, demonstrate that the draft report was not designed to resolve open BFO review issues or disputes in some meaningful fashion. Rather the "draft audit" was intended to punish the principals of WPACC who BFO believes to be responsible for bringing the Action, and to influence the fact finder therein against the plaintiff. The BFO, along with Mr. Keating and other DPW lawyers, thereby violated BFO's own procedural rules for conducting the review, denied WPACC its right to a fair audit, violated WPACC's principal's First Amendment rights to speak freely and to petition government, and colored all of its review comments. The alternative is to look past these factors and legitimately undertake a reasonable and rational response. The conclusion of these matters satisfactory to all participants is currently our goal. It is in this vein that we respond to the "draft audit" hereinbelow.

**Issue 1,
#1 MAYS-Corporate Questioned Costs**

A. Purported Related Party Transactions

The mere fact that transactions were with related parties does not render those expenses unallowable.

1. As you are well aware, Robert J. Powell ceased to own any interest in WPACC and MAYS before June 30, 2008. Accordingly, the Powell Law Group, P.C. (PLG) was not a related party as of June 30, 2008. Mr. Pat Owens was an employee of PLG and provided accounting services for WPACC and MAYS. PLG was reimbursed for the costs of such services and other expenses related thereto. Attached as Schedule #1, A1, are documents to substantiate the salary paid by PLG to Mr. Owens for his services and the support for the other expenses and charges of PLG which were reimbursed by WPACC. Mr. Owens is no longer an employee of PLG and a formal agreement now exists for these services and expenses between Mr. Owens and MAYS. It was executed after the BFO review and memorializes and ratifies the charges.

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2. Attached as Schedule #1, A2, is the office lease between PLG as the tenant, and Big Kahuna Realty, LLC, as the landlord. The portion of the space used by the PLG employee who provides accounting services to MAYS/WPACC is set forth thereon. A formal agreement now exists for these services and expenses. It was executed after the BFO review and memorializes and ratifies the charges.
3. Legal Eye Productions LLC is not a related party to WPACC or MAYS. It is owned and controlled by Vince Sebal, an unrelated person, and was never owned or controlled by Robert Powell the President of PLG. The listing of the President of PLG as the president of Legal Eye Productions is incorrect. In this connection, attached as Schedule #1, A4 is a letter from the owner of Legal Eye Productions. The expenses of \$3,264.48 were for various productions of marketing materials including brochures, DVDs and WEB updates. It is not common business practice for the vendor to provide documentation with their invoicing; it is the responsibility of the payer to be certain the items were received. Copies of the DVDs, brochures, etc. were received by MAYS Corp. and payment was made. We have included copies of the materials with this response and would direct you to the MAYS web site www.midatlanticyouth.com. The expenses are allowed expenses for WPACC's marketing and public relations activities.
4. Virtual Legal Assistant LLC ("VLA") is not a related party to WPACC or MAYS. It is owned and controlled by an unrelated person. In this connection, attached as Schedule #1, A5 is a letter from the President of VLA. The President of VLA is not an employee of PLG and was not at the time of providing services to WPACC. The Principal of Virtual Legal Assistant is self employed and performs paralegal support for a variety of attorneys. The invoice in question was for the preparation of a power point presentation for MAYS. Attached on Schedule #1, A5 is the ownership of Virtual Legal Assistant LLC. The expenses are secretarial expenses for MAYS that were provided by an unrelated third party.

B. Alleged Unsupported Costs - Disagree

1. Because of growing costs associated with automobiles, an agreement was reached between MAYS and the former president of MAYS whereby he would receive a fixed monthly payment to compensate him for his automobile. Since the payment was for use of his automobile it was recorded initially as an automobile expense. It should be properly reclassified as additional employee compensation. In either category it is a bona fide expense of operations.

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2. The expenses disallowed in draft report sections #1, B2 and #1, B3 are for MAYS Corp and were expended in order to complete its responsibilities to MAYS-Butler in the area of marketing and public relations for WPACC, as well as for travel expenses for the CEO and other key employees of MAYS incurred while performing their business functions. These expenses constitute part of the MAYS overhead that is reimbursed as part of the Management Fees paid by WPACC to MAYS. The BFO is well aware that these expenses are included in the MAYS overhead and not separately charged. The CEO and other key employees charged these expenses to MAYS credit cards and credit card supporting evidence has been provided to the BFO auditors. Schedule #1, B2 sets forth further explanation of these expenses. WPACC believes that all of these expenses are supported and justified.

C. Interest Costs

Upon commencement of operations and because WPACC was from its inception a fully staffed facility, the revenues were not sufficient to pay expenses. Indeed, as BFO is well aware, WPACC incurred initial operating losses of \$53,513 in 2004-2005, and \$1,442,458 in 2005-2006. To fund the aggregate operating losses of \$1,495,971, a bank line of credit in the amount of \$750,000 was fully drawn and funds were provided by various loans from PACC to keep the WPACC operation appropriately functioning. Given that some governmental entities deliberately delay paying providers, WPACC's cash management is a critical function of its operations. The borrowed funds in question were used during the start up of the facility which occurred in 2005 and continued into 2007. Repayment to lenders other than S&T Bank was made first with the Bank being substantially repaid in the 2008-2009 fiscal year of operation. Interest expenses that are incurred for bona fide operational debts are allowable and appropriate expenses. Concerning the matter of insurance premiums, due to the high cost of all insurances for WPACC's business (in excess of \$500,000 annually) the premiums are amortized and paid for over the operating year. The ability to pay over time is a cash management tool which helps to even out the cash flow of expenses.

MAYS Corporate Summary

As can be verified from the attached supporting documents, the questioned costs are reasonable and appropriate costs for a company that is charged with managing the facility. The public relations and marketing expenses are ordinary and necessary costs that all companies in this position incur, and in fact from a market prospective we believe that the companies' costs are lower than competing facilities

Mr. Michael J. Kiely
Division of Audit Review
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#2. MAYS-Butler Questioned Costs.

A. Purported Related Party Transactions - Disagree

Marsicano Law Investigations (MLI) is owned by Mr. Michael Marsicano. MLI is not a related party to WPACC or MAYS. Mr. Marsicano is a retired law enforcement official and a licensed private investigator. As such, MLI had been retained to undertake employee background searches. A copy of the agreement between MLI and WPACC for employee background searches is attached as Schedule #2, A. There is no requirement under current law or regulations that requires WPACC to competitively bid these services. The background searches performed, in the opinion of management, went well beyond those that ordinarily accompany Act 33/34 clearances. This provided WPACC and its residents with additional protection.

B. Alleged Unsupported Costs – Disagree

1. Management Fees of \$396,000 or twenty-two (\$22) dollars per bed were charged by Northwestern Human Services (“NHS”), an unrelated **non-profit** third party, to manage a 48 bed facility for PACC, a WPACC sister company, during the fiscal year 2004-2005, see #2. Schedule B1 attached. Given that WPACC is a 72 bed facility, the NHS Management Fee at \$22 per bed for WPACC would have been about \$580,000. The Management Fee of \$547,000 charged by MAYS Butler to WPACC is about \$30,000 less than a comparable third party **non-profit** management fee, and thus the MAYS management fee is unreasonably low. In the County Institutional Facility Per Diem Calculation, WPACC, as a for-profit entity, is permitted a pre-tax profit margin of 16%. Inasmuch as the WPACC aggregate allowed and justified costs and expenses are \$6,544,594, as set forth on Schedule #2, B1, the reasonable pre-tax profit per this established methodology should be \$1,047,135. We hereby adjust the pre-tax profit in the form of a management fee/pre-tax profit for the 2007-2008 fiscal year to \$1,047,135. On an after-tax basis the management fee/profit would be reduced to about \$545,000 **which is still less than the comparable non-profit management fee of \$580,000** determined above. As you are aware, the purpose of the Management Fee is to pay for the other support costs that MAYS Corp. expends to support its mission of full occupancy and program development/assistance along with retaining a fair after tax annual profit. The Management Fee paid to MAYS Corp. allows MAYS Corp. to expend resources in areas which, while not allowable to be billed to counties, are integral in the continuance of its mission to provide quality programs, competent staff and maximum utilization in order to provide those services to counties at a reasonable per-diem.

Mr. Michael J. Kiely
Division of Audit Review
March 6, 2009
Page six

2. A copy of a Management Agreement between MAYS-Corp. and MAYS-Butler is attached as Schedule #2, B2. It was executed after the BFO review and memorializes and ratifies the charges.
3. A copy of the supporting depreciation schedule is attached as Schedule #2, B3.

C. Costs Not Necessary or Related to Facility Operations.

We agree that the \$1,320 expense part of which is a donation to "March of Dimes" should not have been included for reimbursement.

#3. WPACC Questioned Costs.

A. Purported Related Party Transactions.

1. A copy of the agreement between PLG and WPACC is attached. It was executed after the BFO review and memorializes and ratifies the charges.
2. A copy of the lease between WPACC and Big Kahuna is attached. It was executed after the BFO review and memorializes and ratifies the charges.

B. Alleged Unsupported Costs - Disagree

1. The Administrative Fee was reversed, not accrued and not charged in the 2007-2008 fiscal year.
2. We agree the charitable deduction of \$250 to Men of Marian should not be reimbursed.

C. Mortgage Interest Expense

Construction loan proceeds of \$1.0 million were for project Consulting Fees that were paid to the principals of WPACC in 2004. The Consulting Fees were paid to the principals to compensate them for services and carrying costs of developing the WPACC project prior to and during the project's construction. The Consulting Fees were fully disclosed to the bank and were budgeted as "Consulting Fees" and approved as part of the construction loan, see Schedule #3, C attached. As such, the Consulting Fees were built into the transaction financing and were contingent on successful completion of the project. The principals spent over 3 years of time and expense in researching suitable sites, negotiating with prospective sellers, conducting other activities associated with the development of the project along with bearing the total risk of the transaction. Inasmuch as the fee and loan are appropriate, the interest component on this portion of the loan is appropriate and should be allowed.

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**ISSUE 2,
Alleged Billing Errors, Documentation And Luzerne County Billing - Disagree**

A. Billing Errors – Billing staff will be made aware of all pertinent contract payment provisions to ensure accuracy. The contracts for 2007-2008 did allow for billing for day of discharge if discharge occurred after 12:00 noon. The rationale for this charge is that there are expenditures made on behalf of the youth when they do not leave until later in the day. MAYS is in the finishing stages of designing a data based system which will enable it to accurately track youth through its facility and will prepare appropriate billings for both per diem billings and education billings.

B. Court Orders – All necessary documentation including court orders supporting admissions, transfers between programs and discharges of juveniles have been received and maintained appropriately. In the rare circumstance where a court order or other documentation is not received timely a record of the failure to receive and the steps being taken to correct the situation will be kept

C. Luzerne County Placement Agreement – The County and MAYS have ended the contractual relationship with regard to the Shelter Care Beds. MAYS would, when there were empty beds in Shelter Care, make attempts to fill the beds with other than Luzerne County youth as long as Luzerne County approved giving up those beds. There were a number of occasions where Luzerne County would not give approval and the beds remained unfilled and thus were billed to Luzerne County.

**Issue No. 3,
Alleged Lack of Adequate Documentation
Resulted in Internal Control Weaknesses - Disagree**

Lack of Payment Authorization – A written expense policy did exist, see Schedules, Issue #3. A more explicit expense policy has been implemented to reinforce the existing expense policy and further delineate the approval process required to process payments.

Lack of Formal Agreements – The Company is transitioning away from the necessity for inter-company loans. Until the transition is completed the company will prepare documentation to support the loans

Account Coding – Almost all MAYS Butler and WPACC invoices were appropriately coded with the G/L account, date of payment and check number used to pay the invoice. An even more rigorous system has been implemented to ensure that all invoices paid will reflect the G/L account code, date of payment and check number used to pay the invoice.

Mr. Michael J. Kiely
Division of Audit Review
March 6, 2009
Page eight

Lack of explanation of Journal Entries – All General Journal entries had explanations. In the future even more detailed explanations of the purpose of the entry and the location of any supporting documentation will be required.

**Issue No. 4,
Alleged WPACC Did Not Adequately Allocate Costs Among Its Three Programs- Disagree**

WPACC currently only offers Secure Treatment and IORT. Allocations of expenses are based on methodologies that best suit the expense. Costs will be charged to individual programs where the expense can be properly determined. WPACC and MAYS believe the allocation methodologies now in use are appropriate and sufficient.

Attachment A - Improper Audit Matter and Disclosure

The expenses in Attachment A that were heralded by BFO to the news media are not from the fiscal year 2007-2008 under review. Rather, they are from a prior fiscal year. These expenses were recorded by MAYS Corporate as overhead and not charged to the WPACC facility. No effort had been made by WPACC to recover any specific charge for them. Instead, they are items of a compensatory or personal nature that are covered by the MAYS profit distribution structure. BFO sought out these expenses that were incurred before the review period in order to incite a scandal in an effort to harass and embarrass the principal of MAYS and WPACC to dismiss the Action as described on page 1. The BFO's efforts here clearly show that the intent of its audit review of WPACC was not for a bona fide purpose. BFO used this information and the media to violate its own procedural rules for conducting the review, denied WPACC its right to a fair audit, violated WPACC's principal's First Amendment rights to speak freely and to petition government, and colored all of its review comments. We shall address this matter with BFO officials in another forum.

Very truly yours,


William G. Brucker

Enclosures

file

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WILLIAM G. BRUCKER
BERNARD M. SCHNEIDER
CHARLES J. PORTER

Reply to: Main Office

May 18, 2009

VIA TELEFAX AND REGULAR MAIL

Mr. Kevin M. Friel, Director
Bureau of Financial Operations
Department of Public Welfare
Room 525 Health and Welfare Building
Harrisburg, PA 17120

Re: Response to WPACC Audit Report dated February 11, 2009 ~ Second Draft.

Dear Mr. Friel:

At the outset, I wish to thank you for the extension of time to respond to the Second Draft of the Audit Report dated February 11, 2009.

The majority of the issues addressed in the Second Draft were discussed in our response of March 6, 2009, as well as at the conference with you held on March 18, 2009. We offer the following comments to underscore a few of our prior responses to your questioned costs:

1. The proposed administrative fee of \$533,125 was never paid and the journal entry had been reversed in the fall of 2008. Hence, we question why this is even an audit item.
2. The narrative on page 8, item 2, indicates that there was no documentation to support the rent paid to Big Kahuna Realty, LLC. Yet, numerous canceled checks bore notations that they were for rent. Hence, documentation did exist for the rental payments.

Mr. Kevin M. Friel, Director
Bureau of Financial Operations
Department of Public Welfare
May 18, 2009
Page two

3. The management fees paid to PLG were for accounting services. The individual who performed these services met with BFO on many occasions and personally described his services. We have documented the management fees as reimbursement for his actual salary that was substantiated by his W-2s.
4. As discussed in our prior response, the efforts to locate the site and build the WPACC facility required enormous development time and efforts by the principals. As we disclosed in our March 6th response, this fee was budgeted into the financing with the bank. The fee reimbursed the principals for years of work to bring the project to fruition. The development/consulting fee was reasonable and was formally evidenced in writing as part of the financing documents executed by the bank and the parties.
5. As you are aware on June 9, 2009, the current owner bought out a former owner's interest in the companies. In accordance with their acquisition agreement, the bulk of the items shown on page 21 were treated as distributions to the former owner. Accordingly, substantially all of such items listed were not of record on June 30, 2008.
6. The audit continues to ignore the profits that MAYS/WPACC were entitled to charge for their services. As illustrated in our March 6th response, the after tax profit component for WPACC/MAYS is less than the fee charged by the nonprofit entity which operated its sister company. The profit component to MAYS/WPACC is reasonable and the manner in which the MAYS' profits were paid to the principals had no impact or bearing on the cost of operating WPACC.

As first stated, these comments are only meant to underscore a few of the comments and extensive documentation we have previously provided to the BFO.

Very truly yours,



William G. Brucker

APPENDIX B

LUZERNE COUNTY COMMISSIONERS
MARYANNE C. PETRILLA, CHAIRMAN
GREGORY A. SKREPENAK
STEPHEN A. URBAN



FRANK J. CASTANO
DIRECTOR

DOUGLAS A. PAPE
Acting County Manager/Chief Clerk

LUZERNE COUNTY

CHILDREN AND YOUTH SERVICES

111 North Pennsylvania Boulevard Suite 110, Wilkes-Barre, PA 18701-3697
(570) 826-8710 · Fax Number: 570-821-7353
TDD (570) 825-1860

March 17, 2009

Mr. Kevin Friel, Director
Bureau of Financial Operations
PA Department of Public Welfare
3rd Floor Bertolino Building
P.O. Box 2675
Harrisburg, Pennsylvania 17105-2675

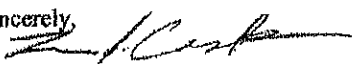
Dear Mr. Friel,

This letter is to serve as a response to the proposed audit report concerning Western PA Child Care, LLC that was provided together with your letter to me dated February 11, 2009.

In its proposed audit report, the Bureau of Financial Operations ("BFO") recommends that Luzerne County "evaluate and make changes to the contract practices that resulted in the payment for empty beds and the reservation of emergency shelter beds in a facility that is more than 260 miles away from the Luzerne County seat". Luzerne County believes that it has already implemented changes that should satisfy or render moot BFO's recommendations. Specifically, Luzerne County did not contract with Western PA Child Care, LLC for the 2008-2009 Fiscal Year. Furthermore, the agreements dated June 30, 2008 between Luzerne County and PA Child Care, LLC for secure detention beds, treatment beds and sexual offender/fire setter beds at the facility in Luzerne County only require Luzerne County to pay for beds as and when needed by Luzerne County.

Thank you for your review and consideration of this response.

Sincerely,


Frank J. Castano

CC: Commissioner Maryanne Petrilla
Commissioner Gregory Skrepenak
Commissioner Stephen Urban
Mr. Doug Pape
Mr. Thomas Pribula
Mr. Brian Bufalino
Mr. Joseph DeVizia
Mr. John Johnson
Mr. Michael Kiely





COMMONWEALTH OF PENNSYLVANIA
DEPARTMENT OF PUBLIC WELFARE
BUREAU OF FINANCIAL OPERATIONS
Room 525 Health & Welfare Building
Harrisburg, Pennsylvania 17105-2675

KEVIN M. FRIEL
DIRECTOR

TELEPHONE NUMBER
(717) 772-2231
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Mailing Date

Mr. Richard Gold
Deputy Secretary for Children, Youth and Families
Health and Welfare Building, Room 131
Harrisburg, Pennsylvania 17120

Dear Mr. Gold:

In response to a request from the Office of Children, Youth and Families (OCYF), the Bureau of Financial Operations (BFO) has completed a performance audit of the psychological evaluations provided to delinquent and alleged delinquent children in Luzerne County (County). The audit was conducted in response to the OCYF's concerns on the amount of State funds being used to fund psychological evaluations and recent newspaper articles relating to the Luzerne Counties purchase of these services. The audit was primarily directed to determine if the psychological services were provided in accordance with 55 PA Code Chapter 3170, and that the costs were adequately supported. This audit addresses costs reported to DPW for the period July 1, 2001 through December 31, 2007.

The audit questions the eligibility of \$836,636 in costs that were funded by the DPW. The report also identifies recommendations for improvement in the management and delivery of services to juvenile offenders.

Luzerne County Psychological Services
Executive Summary

The operation of the County Juvenile Court System is governed by the Juvenile Court Judges' Commission (JCJC). The JCJC standards incorporate the Rules of Juvenile Court Procedure for Delinquency Matters as well as the Juvenile Act. The cost of juvenile services is funded by DPW through expenditure reports submitted by the County C&Y office.

In Luzerne County the JPO makes recommendations to the court that psychological evaluations be completed on identified juveniles to assist in determining the best plan for treatment and rehabilitation. The recommendations to the court are overseen by a licensed social worker. The juvenile court judge makes the final decision on what juveniles should have a psychological evaluation through a court order.

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The psychological evaluations reviewed by the BFO were conducted by a licensed Psychologist who has performed forensic evaluations for the County since 2001. The forensic evaluations include administering and interpreting standard tests and providing recommendations on legal determinations regarding incarceration, treatment and placements. During our audit period the Psychologist performed an average of 124 evaluations per year for the court or an average of 10.3 evaluations per month. In June 2008 the responsibility for Juvenile Court was transferred to another judge. In the three months since the transfer court ordered evaluations have dropped to an average of four a month. If court ordered evaluations continue at this level the annual average will drop from 124 to 48.

FINDINGS	SUMMARY
<p><i>Finding No. 1 – County Failed to Comply with Chapter 3140 and Chapter 3170 Regulations Jeopardizing the Allowability of \$836,636</i></p>	<ul style="list-style-type: none"> • Failure to follow Chapter 3140 and 3170 of State regulations has jeopardized the allowability of \$836,636 in State funding. • The County Probation Department's one page purchase of service agreement with a licensed psychologist was not approved by the County commissioners. • The purchase of service agreements were not competitively procured and were awarded to the brother-in-law of the President Judge. At a minimum this presents the appearance of a conflict of interest. • Although these costs would be eligible for 50% State reimbursement, the County inappropriately claimed reimbursement at an 80% rate resulting in an overcharge of \$313,738.

HIGHLIGHTS OF RECOMMENDATIONS
<p>The OCYF should:</p> <ul style="list-style-type: none"> • Determine the allowability of \$836,636 in costs funded by DPW and recover unallowable funds from the County. At a minimum the OCYF should recover the \$313,738 overpayment that resulted from the inappropriate billing of psychological services at 80%. • Instruct the County that reimbursement of court ordered psychological evaluations be billed at 50% and not 80% reimbursement. <p>The County should:</p> <ul style="list-style-type: none"> • Ensure all contracts, including JPO contracts, are signed by the County Commissioners. This will provide additional assurance that the contract complies with DPW requirements and that the contract was awarded in an open and public manner. • Discontinue the practice of seeking 80% reimbursement for a court ordered examination which is reimbursable at 50%.

**Luzerne County
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July 1, 2001 through December 31, 2007**

FINDINGS	SUMMARY
<p><i>Finding No. 2 – County Evaluations Were Billed at an Average Cost of \$1,635 per Juvenile- Approximately 3.6 Times the Current Health Choices Rate</i></p>	<ul style="list-style-type: none"> • The average cost per evaluation was \$1,635 and was based on 18.2 hours at a \$90 rate. • More than 50% of the hours billed were based on estimates and not the actual time to perform the tasks. • 40-50% of written reports were comprised of “copied and pasted” standardized footnotes. • Copying and pasting also resulted in one instance where an evaluation references a different child than the one purported to be evaluated. • Beginning in July 2008, the cost of evaluations for MA eligible children will be 100% funded by Health Choices at a \$450 rate regardless of the hours needed to complete the evaluation.

HIGHLIGHTS OF RECOMMENDATIONS
<p>The County should:</p> <ul style="list-style-type: none"> • Adopt the MCO rate for psychological evaluations performed on non-MA eligible juveniles. <p>The OCYF should:</p> <ul style="list-style-type: none"> • Monitor the County to ensure that the rate charged to DPW Act 148 funds is the same as the MCO rate. If the County contracts at a higher rate, the difference for evaluations for non-MA eligible children should be paid with County funds.

FINDINGS	SUMMARY
<p><i>Finding No. 3 – Process used by JPO to make recommendations to the Court could be improved</i></p>	<ul style="list-style-type: none"> • The County reimbursed a licensed psychologist \$1.1 million to receive expert opinions and recommendations regarding juvenile treatment and rehabilitation options. • In a number of cases (5 of 31) the Psychologists' recommendations were not implemented. • The documentation of the process and practices used to make recommendations to the Court could be improved.

**Luzerne County
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HIGHLIGHTS OF RECOMMENDATIONS

The Court and JPO should:

- Should redefine the process in making recommendations to the Court on the placement and treatment of children

The JPO should:

- Document the basis for recommendations made to the Court regarding evaluations and options for treatment and rehabilitation.
- Document the specific reason for non-acceptance or disagreement with the Psychologist recommendations.

Background

The Juvenile Act was created to set guidelines for JPOs to provide programs of supervision, care, and rehabilitation, which provide balanced attention to the protection of the community for children committing delinquent acts. The Act also requires that JPOs ensure children have an understanding of accountability for the offenses committed and the development of competencies to enable them to become responsible and productive members of the community.

The JPO provides these services and programs with the costs reported to DPW through the County C&Y. In fiscal year 2006-07, the County JPO incurred costs of \$11,307,272 for juvenile services. These costs are funded by DPW at reimbursement rates ranging from 50 to 80%, with the County funding the balance. For fiscal year 2007-08, reported costs were reduced to \$10,826,242. The costs do not include the salary and benefits of JPO staff, which are not funded through DPW.

Included in the JPO costs is the cost for psychological evaluations. For the period July 1, 2001 through June 30, 2008, the county reimbursed the Psychologist \$1,122,025 for these services.

Objective, Scope and Methodology

The audit objectives were:

- To determine if psychological evaluations billed to DPW were provided in accordance with 55 PA Code Chapter 3170 regulations.
- To determine if payments to the Psychologist were supported by valid documentation.

In pursuing these objectives, the BFO interviewed staff from the County C&Y, JPO, the Court Human Resource Director and the Psychologist. We also reviewed County C&Y invoices, financial records, the Psychologist billings and evaluations, case files, and

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other pertinent data necessary to complete our objectives. Our review covered the period July 1, 2001 through December 31, 2007. However, our testing and review of the psychological evaluations and billing documents were limited to the period July 1, 2004 through December 31, 2007.

Government auditing standards require that we obtain an understanding of management controls that are relevant to the audit objectives described above. The applicable controls were examined to the extent necessary to provide reasonable assurance of the effectiveness of those controls. Based on our understanding of the controls no significant deficiencies came to our attention other than those described in the findings included in this report.

The audit fieldwork was conducted intermittently between June 30, 2008 and September 3, 2008 and was performed in accordance with general accepted government auditing standards. The report, when presented in its final form, is available for public inspection.

Results of Fieldwork

Finding No. 1 – The County Failed to Comply with DPW's 3140 and 3170 Regulations Jeopardizing Allowability of \$836,636

The Standard County Purchase of Service Agreement was not used by the Juvenile Probation Department in the purchase of Psychological Services. The agreement used since February 2003 was limited to a one page document that was signed by the former Director of Probation Services.¹ The agreements were not approved by the Chairperson of the County Commissioners or an authorized representative as required by Regulation 3170.93(e)(i).

During the period July 1, 2001 through December 31, 2007, the County reimbursed the Psychologist \$1,045,795 to perform psychological evaluations for the court. The County also reimbursed the Psychologist an additional \$76,230 for the period January through June 2008. Reimbursement for this period was not included on the DPW claim due to the absence of a valid contract. In total the \$1,122,025 paid to the Psychologist resulted in \$836,636 of reimbursement by DPW (\$1,045,795 @ 80%). The eligibility of these costs is being questioned due to the fact that the County did not procure the services, establish the hourly rate, or report the costs using the correct reimbursement rate in accordance with DPW Chapter 3140 and 3170 regulations.

The Court and JPO began using the Psychologist during calendar year 2001. The process utilized by the JPO to procure the services was limited to a review of a résumé and a comparison of work products of the Psychologist to that of an existing contractor.

¹ The BFO requested the written Agreements for psychological services dating back to the 2001 service inception. The JPO could not locate or determine the existence of a written Agreement prior to February 1, 2003.

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An hourly rate of \$85 was offered to and accepted by the Psychologist. The rate was increased to \$90 during fiscal year 2002-03. The process used to procure the services did not comply with requirements of 55 PA Code Chapter 3170.81-3170.86. Specifically Chapter 3170.83 requires the County to either request bid proposals in writing, in which County code sections will apply on how contract will be awarded, or the County may establish a maximum rate or range of rates for the service to be purchased. These rates shall be developed considering the reasonableness of cost for the service, in an open and public manner, and must be updated on an annual basis. Neither method was employed by the County in their procurement of the services.

The former Director of Probation Services, who signed the annual Agreements, informed us that he was not aware of the existence of the Chapter 3170 Regulations, the specific requirements related to procurement of services, or that the regulations applied to JPO services.

In addition to the procurement requirements provided in Chapter 3170.81-3170.86, the Luzerne County Commissioners approved and adopted a Procurement Manual in April 2004. The procedures outlined in the manual were to be followed by all units of County government including the courts. According to the manual all professional services exceeding \$7,500 are to be procured through a request for proposal (RFP) published in the daily newspaper. The RFP process was not used by the JPO for the purchase of the psychological services. In our attempt to determine why, we were informed, by the former Director of Probation Services, that the manual was never formally transmitted to his Department nor was training provided to implement the requirements of the Purchase Manual.

Contract Requirements and Disclosures

Chapter 3170.23(b) requires that the County adhere to contract requirements outlined in 3170.93. Specifically, 3170.93(e) outlines a list of required elements that must be contained in service contracts or agreements. The one page agreement approved annually by the County Probation Department lacked a number of required elements.

Moreover, Chapter 3170.93(g) requires the County to notify and obtain approval from the OCYF regional office before a contract or agreement is awarded to members of its staff or immediate families. The JPO is a Department of the Court under the authority of the County President Judge. The brother-in-law of the Psychologist at the time the February 2003 Agreement was awarded was the President Judge.² According to the former Director of Probation Services, about a year after the Psychologist began providing services he became aware of the relationship between the President Judge and the Psychologist. However, he was unaware of the requirements in the 3170 regulations and did not request approval of the contracting arrangement. At a minimum,

² The Psychologist began providing JPO services in 2001. The Psychologist's brother-in-law became President Judge in 2002.

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we believe that the awarding of a JPO contract to the relative of the President Judge from 2003 through 2007 presents the appearance of a conflict of interest.

Reporting the Cost of Psychological Evaluations as 80% Reimbursement Results in a \$313,738 Overcharge

According to Chapter 3140.23, the allowable reimbursement level for medical and other examination ordered by the Court is 50%. The County reported the costs of the court ordered psychological evaluations as 80% reimbursable. As a result the DPW was billed and paid \$313,738 more than would be appropriate had the services been procured in accordance with the requirements detailed in the Chapter 3140 and Chapter 3170 regulations. Note that the \$313,738 is included as a component of the \$836,636 total questioned costs due to noncompliance with 3140 and 3170 regulations.

Per regulation 3140.22, for a cost to be reimbursed at 80%, it must be a counseling or intervention service provided to a child, or child's family, and directed at alleviating conditions which present a risk to the safety or well being of the child. The psychological evaluations, we reviewed, are more appropriately defined as a medical/other examination that was ordered by the Court and should be reimbursed at 50%.

Recommendations

The BFO recommends that OCYF determine the allowability of the \$836,636 in DPW funding received by the County for psychological services that were not procured in accordance with the requirements of Chapter 3140 and Chapter 3170. The OCYF should note that a decision to agree to participate in these costs will then require that they enter into negotiations on the recovery of the \$313,738 over billing that resulted from the inappropriate classification of these court related costs as 80%reimbursable.

The BFO also recommends the County C&Y office discontinue the practice of seeking 80% reimbursement for evaluations ordered by the court. These evaluations should be billed at 50%. The OCYF should monitor the annual fee for service schedule submitted with the County's fiscal summary to ensure reimbursement for these costs is limited to 50%.

The BFO finally recommends all contracts and/or purchase of service agreements use the standard boiler plate language and be approved by the County Commissioners. Contracts for JPO service should also be reviewed by the County C&Y fiscal officer who is knowledgeable of the 3170 requirements. These practices will provide additional assurance that the contracts comply with DPW requirements and are awarded in an open and public manner.

**Luzerne County
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Finding No. 2 - County Evaluations Were Billed at an Average Cost of \$1,635 per Juvenile-Approximately 3.6 Times the Current Health Choices Rate

Prior to July 2008, psychological evaluations ordered by the Court were eligible for 50% reimbursement from DPW through Act 148; the remainder was to be funded by the County. Beginning in July 2008, medically necessary psychological evaluations for juveniles who are MA eligible will no longer be funded with Act 148 funds, but rather through the DPW Health Choices Program. Community Care Behavioral Health, the local managed care organization under health Choices, will manage the psychological testing for children including the payment for the service. The current rate for the MA eligible evaluations performed by the Psychologist, whose services are the subject of this audit, is \$450, regardless of the amount of time needed for testing, scoring and reporting. Evaluations funded by MA are provided at no cost to the County.

In March 2008 the County issued a Request for Proposal (RFP) to procure the services of a licensed psychologist to deliver psychological evaluations for non-MA eligible children. A contract is anticipated to be awarded in the Fall of 2008. The RFP does not specifically state whether the proposal should be based on a maximum rate per evaluation or on an hourly rate. The RFP also does not address the testing to be included in the evaluations. We believe it would be appropriate for the County to limit the reimbursement to the amounts paid for MA eligible children.

Evaluations were performed at an annual cost of \$1,635

We tested the documentation to support the Psychologist's billings for 31 evaluations completed between July 2004 and December 2007. In all cases the evaluations were performed and a written report was provided to the JPO detailing recommendations for treatment and rehabilitation. The tests identified on the billings were provided and documented in the evaluations. The 31 evaluations represented seven percent of the 433 evaluations performed during this period.

Our review of the Psychologist's invoices submitted and billed to DPW identified the following:

- The evaluations included the administering of four standard tests for nearly every child. The tests included screening for organic damage, I.Q. and personality. Our sample identified three children who were evaluated twice within a one year period, and the standard tests were administered in both evaluations.

The average cost per evaluation was \$1,635 based on 18.2 hours at \$90. The invoices categorized the average hours as: four hours for record review, clinical interview and administering tests; 10.5 hours for test scoring and interpretation; and 3.5 hours for report writing. The hours reported for each child to score and interpret test results were the same. For example, the hours to score and interpret the tests were 10.5 hours for almost every child. According to the Psychologist, the reported hours for scoring and interpretation were not based on

**Luzerne County
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actual hours but were estimates developed on the average time per child established over a period of time.

- A schedule of the hours of service billed indicates that the Psychologist worked seven days per week. Hours billed on Saturday and Sunday were similar to those billed on weekdays.
- For fiscal year 2006-07, the billings included eight days where reimbursement was requested for 12 or more hours. On two of the days he billed and was reimbursed for 16 and 16.5 hours. In response to our questions related to these eight days the Psychologist responded that he sometimes works 12 to 14 hours per day on County referrals and the 16 and 16.5 hours must be a mistake.
- Each evaluation identified an average of 3.5 hours, or \$315 in costs for report writing. The written report provided to the JPO averaged 30-35 pages. Approximately 40-50% of the report represents standard boilerplate footnotes explaining definitions, case law, test scoring, etc. In one report we noted that a "copy and pasting" resulted in the identification of two different children in one report. The Psychologist acknowledged report write-up time and cost would be reduced without the use of footnotes, but insisted the footnotes were needed to educate the users of the report, and for legal purposes. He also informed us that the name switch in the report had no bearing on the accuracy of the evaluation as each child fit into the same profile.

Recommendations

The BFO recommends the County use the approved MCO rate to reimburse evaluations performed on non-MA eligible clients. For exceptional cases requiring additional testing, the specific tests to be administered should be agreed upon before the tests are administered.

The BFO also recommends that OCYF recognize the rate paid by the MCO as the maximum charge that Act 148 funds will participate in. If the County contracts at a higher rate, the difference should be paid with County funds.

Finding No. 3 - The Process Used to Make JPO Recommendations to the Court for Evaluations and Treatment Options Could Be Improved

Since 2001 the County reimbursed a psychologist approximately \$1.1 million for opinions and recommendations on the treatment and rehabilitation options for delinquent children. In a number of cases we noted that the recommendations were not considered and/or not accepted.

In our review of the sample cases we identified situations that provide the County and the JPO with opportunities to improve the process used to make recommendations to the Court concerning the need for psychological evaluations for treatment and

**Luzerne County
Psychological Services
July 1, 2001 through December 31, 2007**

rehabilitation options. These improvements are primarily in the area of additional documentation in the case files and changes to and/or documentation of the existing model and practices. The need for improved documentation is supported by the following:

- We were informed that a collaborative approach involving intake and case management staff is used to make Court decisions. Documentation that would support the existence of and use of this process could not be located.
- The recommendations to the Court regarding evaluations and options for treatment and rehabilitation are overseen by a licensed social worker. This individual does not have regular contact with the JPO staff and the children involved in each recommendation. The recommendations are provided without apparent oversight by the Deputy Director of Administration. He is responsible for supervision of the JPO intake workers, case managers, and probation officers who should have a significant role in recommendations to the Court.
- During the period October 2005 through late in calendar year 2006, the case files did not contain documentation that would allow us to determine who made the recommendation to the court as to which children should be referred for evaluation.
- In some cases, the Psychologist's recommendations regarding the type of treatment and or type of placement were not followed by the Court. We noted a number of reasons for this including the opinion of the licensed social worker differed from the Psychologist; the recommended service provider did not have an available bed, or the Court elected to disregard the Psychologist's recommendation.
- Five of 31 evaluations included a recommendation to provide the children with a neurological test and evaluation. None of the court orders included this recommendation.

Recommendations

The BFO recommends the Court and JPO redefine the process in making recommendations to the Court on the placement and treatment of children. The current process allows a caseworker to control the recommendations going to the Court. According to JCJC standards the JPO Deputy Chief of Administration should have overall responsibility in making juvenile treatment and rehabilitation recommendations to the court.

The BFO also recommends the basis for recommendations made to the Court regarding what children should receive a psychological evaluation be documented for both MA and non-MA children. The collaborative model which includes the MH forensic caseworkers, intake workers, and probation officers should be followed in making

**Luzerne County
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recommendations to the Court. This model provides the best opportunity to incorporate the expertise and opinion of the JPO staff directly involved in working with the child and family.

The BFO further recommends the specific reason for non-acceptance or disagreement with the Psychologist recommendation by the JPO be documented and provided to the Court for their consideration.

An audit exit conference was held on November 24, 2008 with the County Manager, Assistant Solicitor, and Directors of the Office of Human Services, Office of Children and Youth and Probation Services. At the conference, the findings and recommendations in the draft report and the County response were discussed. As a result of this meeting and discussions with personnel assigned to the Luzerne County Court we made minor changes to the draft report. We also added footnotes to Pages 6 and 7.

The County written response has been incorporated into the final report and labeled Appendix A. In the response the County proposes that the Psychologist was a consultant that provided treatment and placement recommendations to develop the family service plan (FSP) and arrange for the provision of needed services. Based on our review of the services charged, the auditors cannot agree that the services, as provided, meet the DPW's definition of consulting services as defined in the bulletins for Invoicing Procedures for County Child Welfare Services. While the auditors agree that the results or recommendations of the psychological examinations may be used for the FSP the purpose of the evaluations as described in the court orders was to assist the court in making its determination and not to develop the FSP.

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

Please contact Alexander Matolyak, Audit Resolution Section at (717) 783-7786 if you have any questions concerning this audit or if we can be of any further assistance in this matter.

Sincerely,



Kevin M. Friel

Attachment

c: Mr. Thomas Diehl
Mr. Edward Coleman
Mr. Frank Castano

bc: Mr. Alex Matoylak
Mr. Thomas Crofcheck
Mr. Jack Hoover
Audit File (N7004)

**Luzerne County's
Response to the Draft Report**

LUZERNE COUNTY COMMISSIONERS
MARYANNE C. PETRILLA, CHAIRMAN
GREGORY A. SKREPENAK
STEPHEN A. URBAN



FRANK J. CASTANO
DIRECTOR
DOUGLAS A. PAPE
Acting County Manager/Chief Clerk

LUZERNE COUNTY
CHILDREN AND YOUTH SERVICES

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November 18, 2008

Mr. Kevin Friel, Director
Bureau of Financial Operations
PA Department of Public Welfare
3rd Floor Bertolino Building
P.O. Box 2675
Harrisburg, Pennsylvania 17105-2675

Dear Mr. Friel,

This letter is to serve as the Luzerne County response to the proposed audit report concerning psychological evaluations that was provided together with your letter to me dated October 23, 2008.

1. Background: The Pennsylvania Department of Public Welfare ("DPW") has reimbursed Luzerne County \$836,636 (the "Evaluation Reimbursements") of the costs incurred by Luzerne County for services (the "Evaluation Services") rendered by a licensed psychologist (the "Psychologist") during the period from July 1, 2001 through June 30, 2008. In its proposed audit report, the Bureau of Financial Operations ("BFO") challenges the eligibility of the Evaluation Reimbursements. Luzerne County respectfully submits that applicable regulations do support the eligibility of the Evaluation Reimbursements.

2. Service Procurement and Rate Determination: Luzerne County submits that the procurement of the Evaluation Services and the rates that were established for the Evaluation Services complied with 55 PA Code Section 3170.49, which applies to the procurement of services from "professional practitioners and consultants" such as those that were provided by the Psychologist. Section 3170.49 reads in pertinent part as follows:

3170.49. Purchased personnel services.

(a) *Consultants.* This is an allowable expense for programmatic or administrative reasons. The Department will participate in the cost for fees and expenses of professional practitioners and consultants who are not regular employees, but are engaged as independent contractors for specified services and reimbursed by contract for a specific fee. A written agreement is required for consultants. This agreement shall state the services to be provided, the rate, and the method of payment.

(b) *Fee determination.* The fee charged by such consultants shall be determined in accordance with §3170.84 (relating to maximum levels of reimbursement)."

3. Contract Requirements: Section 3170.49 requires that there be a written agreement with the professional practitioner or consultant and that the "agreement state the services to be provided, the rate, and the method of payment." The written agreement between Luzerne County and the Psychologist does state the service, the rate and the method of payment and thus is in compliance with Section 3170.49.

4. Conflict of Interest: Luzerne County notes that BFO makes reference in its proposed report to Section 3170.93(g) which relates to conflicts of interest and that BFO states that it believes that there is an "appearance of a conflict of interest" regarding the agreement with the Psychologist. Please note that Luzerne County has not renewed its agreement with the Psychologist. Since BFO makes no finding of a conflict of interest or of a violation of Section 3170.93(g), Luzerne County does not address that issue in this document other than to assure BFO that Luzerne County is committed to an open and transparent procurement process. Luzerne County has demonstrated that commitment by enacting and enforcing a rigorous purchasing policy that goes beyond the requirements of the County Code. Any allegation of a conflict of interest has and will be taken very seriously and will be dealt with in a prompt and appropriate manner.

5. Reimbursement Rate: Luzerne County submits that Section 3140.22(f)(10) applies to the reimbursement rate of these Evaluation Services. Section 3140.22(f)(10) provides a reimbursement rate between seventy-five percent (75%) and ninety percent (90%) for "County agency staff activities provided to determine what services are needed, to develop a service plan and to arrange for provision of needed services." The evaluations provided by the Psychologist were provided to Luzerne County as part of and in furtherance of staff activities aimed at determining the service needs of certain juveniles. BFO correctly states in its proposed report that the Luzerne County Juvenile Probation Office recommended the use of the Psychologist's services to "assist in determining the best plan for treatment and rehabilitation" for certain identified juveniles (Page 2 of BFO's proposed report). Since the Evaluation Reimbursements that Luzerne County received over the past seven (7) years at the eighty percent (80%) reimbursement rate are within the seventy-five percent (75%) to ninety percent (90%) reimbursement rate prescribed by Section 3140.22(f)(10), Luzerne County requests that no portion of the Evaluation Reimbursements be considered an over billing or otherwise deemed ineligible for reimbursement.

6. Current and Future Practices: Notwithstanding the foregoing, Luzerne County understands and appreciates BFO's concerns regarding the prior service procurement processes and practices that were followed relative to the Evaluation Reimbursements and has already implemented changes to such processes and practices that should satisfy BFO's recommendations with respect to contracts, services and reimbursements on a going forward basis.

Thank you for your review and consideration of this response. We look forward to participating in the exit conference currently scheduled for November 24, 2008.

Sincerely,

Frank Castano

CC: Commissioner Maryanne Petrilla
Commissioner Gregory Skrepenak
Commissioner Stephen Urban
Mr. Doug Pape
Mr. Thomas Pribula
Mr. Brian Bufalino
Mr. Joseph DeVizia
Honorable Mark Ciavarella
Mr. Larry Saba
Mr. John Johnson





COMMONWEALTH OF PENNSYLVANIA
DEPARTMENT OF PUBLIC WELFARE
BUREAU OF FINANCIAL OPERATIONS
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KEVIN M. FRIEL
DIRECTOR

January 11, 2008

Mr. Richard Gold, Deputy Secretary
Office of Children, Youth, and Families
131 Health and Welfare Building
Harrisburg, Pennsylvania 17120

Dear Mr. Gold:

In response to a request from a previous Deputy Secretary for Children, Youth and Families, the Bureau of Financial Operations (BFO) conducted an audit of the PA Child Care, LLC (PACC). PACC was the primary provider of juvenile detention services in Luzerne County until January 1, 2005, when Luzerne County became the licensed entity to provide these services. The PACC audit was an extension of the statewide audit of all juvenile detention centers in the Commonwealth. The audit was included in the Department of Public Welfare (DPW) 2004-05 Annual Agency Audit Plan.

The mission of the BFO, accomplished through audit and review activities, is to assist DPW management to administer human service programs of the highest quality, at the lowest cost, with integrity.

Results in Brief

- **Reasonableness of Contract:** Based on the calendar year 2003 certified audit, PACC achieved a profit of \$1.2 million from revenues of \$4.3 million or a profit of 28 percent. Based on available data for calendar year 2004, PACC was projected to have a profit of \$1.9 million on revenues of \$5.6 million or 34 percent. In addition, based on the information provided to BFO as part of the audit, PACC daily rates exceeded actual costs by an average of \$85 for detention services and \$109 for treatment services. For detention services, the PACC per diem rates exceeded the average rate for the region by \$78.55 for Fiscal Year 2003-04 and \$85.26 for Fiscal Year 2004-05. The \$85.26 matches the average amount that the PACC detention rates exceeded actual costs. The PACC rates were 40% and 42% higher than the regional average for these two years. The BFO believes that the Department must evaluate this financial arrangement to determine if the contracting and claiming

Richard Gold
Doc's submitted by *A Gold*

Results in Brief (Continued)

process (described in more detail in the body of the audit) met state and federal contracting rules designed to ensure that profits are limited to what is "fair and reasonable" and that all costs billed for by Luzerne County were eligible costs.

- **Type of Lease:** Based on the information provided to BFO, the January 2005 lease arrangement between PACC and Luzerne County appears to be a capital lease. If the Department determines that the lease does in fact meet the definition of a capital lease, it must make appropriate changes to State Act 148 funding of that lease. If the lease is determined to be a capital lease, adjustments to return State and federal reimbursements would exceed \$1.6 million annually for the term of the lease.
- **Contract Terms:** The contract between PACC and Luzerne County includes several provisions not normally seen in similar arrangements throughout the Commonwealth. These contract terms may have contributed to inappropriate billings from PACC to Luzerne County and subsequent inappropriate billings to the Commonwealth and federal government. In all, BFO is questioning \$387,359 in costs submitted for reimbursement to the Commonwealth.
- **Billings to National School Lunch Program:** In seeking reimbursement for staff lunches, the U.S. Department's of Agriculture National School Lunch Program was overbilled by \$11,472.51.

Executive Summary: Subsequent Events and Auditor's Commentary

Upon release of the draft audit to the Luzerne County Children and Youth Program and PACC in February 2007, PACC provided a written response in March 2007. After reviewing the response, the Department informed the Luzerne County and PACC representatives that the DPW would make any changes appropriate to the draft as a result of an independent review.

Subsequently, a revised draft audit was issued on September 25, 2007. The DPW held several meetings with both Luzerne County and PACC. Upon review of the responses submitted from both Luzerne County and PACC, an auditor's commentary was prepared and included in the report.

Omitted Documents and Information

In accordance with Government Auditing Standards we are required to report on information that was omitted from this report and the effect of the omission. PACC requested that certain financial documents be kept confidential and they are not included in the report but will be provided to the Office of Children, Youth and Families under separate cover.

AUDITOR'S COMMENTARY

The County asserts that the lease with PACC was its best and only option

The lease, in its present form, was not the sole and best option for the county as several other options existed including building of a county-owned facility and utilization of facilities in neighboring counties.

The County asserts that detention and secure residential costs were reduced as a result of the lease

The DPW was unable to validate this assertion. The DPW made requests to both Luzerne County and PACC to provide any detailed information in the form of cost schedules, contracts or other appropriate documents to verify this claim. Despite these requests, the DPW never received documentation supporting this assertion.

The County asserts that it is better to serve children close to home

Despite the position stated in its response, Luzerne County has utilized facilities both close to home and others that are at a distance. Of specific note, the County purchased in excess of one million dollars in services from a facility operated by PACC during FY 06-07, located in Butler County – more than 236 miles from Wilkes Barre despite the availability of facilities that are geographically much closer to Luzerne County.

PACC Responses

PACC Asserts that its Lease is Not a Capital Lease

The BFO believes that the analysis provided in the audit report is sufficient to show that the lease is in fact a capital lease. In addition, PACC's Chief Financial Officer stated that the lease was a capital lease in a meeting with the Department in October 2007.

PACC Disputes Amount of Profit for 2003 and 2004

Subsequent to the completion of fieldwork, PACC provided a pro-forma financial presentation for 2003 and a 2004 independent CPA audit. BFO found the amounts and classifications of certain costs in both documents to be either unreasonable or properly classified as profit or return to ownership.

PACC asserts that its Lease with the County has allowed the County to Realize Substantial Savings

As noted in the auditor's commentary on the Luzerne County response, neither PACC nor the County has provided any detailed information to support this assertion.

PACC Asserts That The County Did Not Fail to Negotiate its Contract

BFO has not been provided, nor has it uncovered, any evidence that the County completed the required cost analysis prior to entering into an agreement with PACC.

PACC Asserts That it Did Not Improperly Invoice For Both the Day of Admission and Discharge

The PACC agreement was unique from other County Juvenile Probation Purchase of Service Agreements and did not include standard language prohibiting payment for both the first day of care and the day of discharge.

Background

PACC is a Pennsylvania limited liability corporation with offices at 10 Fox Run Road in Drums, Pennsylvania. PACC owns a 48-bed juvenile detention facility located in Luzerne County at 701 Sathers Drive, Pittston Township, Pennsylvania. The facility provides services to alleged and adjudicated delinquent youths. The facility is licensed to provide 24 beds for secure juvenile detention services and 24 beds for secure treatment services. Subsequent to the leasing of the building to Luzerne County, PACC expanded the building size and the facility was licensed for a total of 60 beds in September 2005.

PACC started operations in February 2003. By April 2003, the program was fully operational. For the 12-month period ended June 30, 2004, the occupancy of the detention program was 92 percent of licensed capacity, and the occupancy for secure treatment was nearly 100 percent. PACC provided services under the terms and conditions of purchase of service agreements with various counties in the Commonwealth. Luzerne County accounted for 99 percent of the company's fee income for calendar 2003. For calendar 2003, the PACC had total income of \$4.3 million and earned \$1.2 million of net income/profit.

Effective January 1, 2003, PACC entered into a 24-month Juvenile Detention Facility Management Agreement with Northwestern Human Services of Pennsylvania, Inc. (NHS) to manage and operate the facility. NHS is a non-profit corporation located in Harrisburg, Pennsylvania. In addition to managing facilities, the NHS is licensed to directly provide child welfare services in the Commonwealth. The terms of the management agreement (Page 10, Item #6, "Managers Compensation") provided for annual compensation of \$396,000. Additionally, the agreement required NHS to provide all executive and direct service staff for which reimbursement from PACC was based on actual costs.

Effective January 1, 2005, Luzerne County became the licensed entity for the juvenile detention facility and assumed responsibility for operation of the detention and treatment programs. Luzerne County entered into an interim contract with NHS to

Background (Continued)

manage the facility. Luzerne County also entered into a 20-year lease agreement with PACC to lease the PACC facility. The terms of the lease require payments of \$2.3 million per year based on the existing 48-bed facility. The payments increase to \$2.9 million per year upon completion of a 12-bed addition. The 20-year minimum payments total \$58 million without consideration of the additional yearly rent based on the increase in the consumer price index.

Luzerne County receives reimbursement for children and youth services such as the detention and secure treatment services provided through the PACC facility from a variety of federal and state funding sources. These include the federal TANF and Title IV-E programs, and the Commonwealth Act 148 allocation. While most detention expenses are reimbursed 100 percent through TANF¹, secure treatment costs are reimbursed through a combination of Act 148 and County funds. Luzerne County, as operator of the PACC facility and a recipient of federal funds, is subject to adhere to federal and state fiscal policies. Specifically, these policies are addressed in:

- The Pennsylvania Code Title 55, Chapter 3170 regulations, Allowable Costs and Procedures for County Children and Youth.
- The Code of Federal Regulations, Title 45, Subtitle A, Part 92.
- The Office of Management and Budget Circular A-87, Cost Principles for State and Local Governments.

Objective, Scope and Methodology

The following objectives were developed for this audit and were discussed with PACC representatives at our November 3, 2004 entrance conference:

- To determine the actual cost of service to residents and determine if the costs were reasonable and consistent with applicable cost principles.
- To determine if the proposed juvenile detention facility lease between Luzerne County and PACC will be cost effective for Luzerne County.

The scope of our audit was limited as we were denied access to the source records pertaining to the PACC building costs and general and administrative expenses. PACC officials informed us that they considered these records to be proprietary. Because of this scope limitation, we were unable to satisfy ourselves as to the composition, reasonableness, and allowability of these expenses. In order to identify the actual cost of services, we accepted and relied upon the building and administrative costs included in the PACC calendar 2003 certified audit.

¹ Beginning January 1, 2006, detention services are no longer eligible for TANF funding.

Objective, Scope and Methodology (Continued)

As stated, our second objective was to determine if the proposed PACC lease would be cost effective to Luzerne County. The County agreed to lease the facility on November 17, 2004 prior to our review of the lease terms. As a result we limited our objective to a review of the allowability of rental costs for federal and state reimbursement.

The scope of our audit was also limited by litigation brought by PACC. On December 17, 2004, PACC, through their attorneys, filed a civil action in the Luzerne County Court of Common Pleas alleging the Luzerne County Controller and DPW staff had and will divulge trade secrets of PACC. This action resulted in the court granting a motion for sealing of records and a special injunctive order prohibiting communicating or disclosing trade secrets of PACC. Due to this action, we were not able to fully complete our audit procedures. For example, existing requests for documents were not satisfied, and our examination of certain documents such as the PACC lease was limited to review of a proposal and not the final signed and executed lease agreement. Additionally, we were not able to review and discuss the report findings and recommendations with PACC and Luzerne County officials prior to preparing this report.

Government auditing standards require that the BFO obtain an understanding of management controls that are relevant to the audit objectives described above. The applicable controls were examined to the extent necessary to provide reasonable assurance of compliance with generally accepted accounting principles. Based on the BFO understanding of the controls, no significant deficiencies came to our attention other than those described in this report.

In pursuing our objectives, we reviewed available fiscal/accounting records, audits, contracts, census reports, client data, and invoices and billings submitted to the County programs. We also reviewed the PACC operations and the financial impact on Luzerne County for compliance with DPW and federal regulations. In addition, we attended meetings and had discussions with representatives of PACC, NHS, and the Luzerne County Juvenile Probation Department. Our fieldwork was conducted intermittently between November 3, 2004 and December 3, 2004. Our work was conducted in accordance with generally accepted government auditing standards. This report, when presented in its final form, is available for public inspection.

Results of Fieldwork

Issue No. 1 The Department Needs to Determine the Reasonableness of the Contract between PACC and Luzerne County, Contract Rates and Invoicing Practices

Results of Fieldwork (Continued)

State and Federal Contracting Requirements

Services provided at PACC are reimbursed by the contracting county on a per diem basis. Per diems should be developed based upon historical data, including actual costs and occupancy data (if available) or upon budgeted costs and projected occupancy data when historical actual cost and occupancy data is not available. Once developed, the per diem should be scrutinized by the appropriate contracting office to ensure that the best possible rate is obtained. To do so, officials are responsible to conduct formal rate negotiations, as required by the standard found at Chapter 3170.83(b) of the Pennsylvania Code, which states that "the appropriate county authorities shall negotiate agreements with providers of services". County officials are expected to act as "prudent buyers" and obtain the best possible rate for services. As such, these negotiations should result in reasonable and fair market prices.

Additionally, the Code of Federal Regulation, Title 45, Subtitle A, Part 92.36(f) (1) states, "Grantees and sub-grantees must perform a cost or price analysis in connection with every procurement action including contract modifications...A cost analysis will be necessary when adequate price competition is lacking..." Further, Part 92.36 (f) (2) requires, "grantees will negotiate profit as a separate element of the price for each contract in which there is no price competition and in all cases where cost analysis is performed." The profit should be "fair and reasonable". The BFO believes a profit not exceeding 10% could be considered fair and reasonable.

Since the PACC facility is the sole detention facility in Luzerne County, adequate price competition is lacking. As a result, the County should have performed a cost analysis of the PACC per diems. We were unable to verify if any negotiations of the per diem rates occurred and Luzerne County and PACC officials provided no evidence of price negotiations.

The BFO's review of the financial records indicates that during calendar year 2003, PACC earned \$1.2 million profit on revenues of \$4.3 million (28 percent profit). During calendar year 2004, we projected the PACC profit to approximate \$1.9 million on revenues of approximately \$5.6 million (34 percent profit). These profits illustrate that the per diems paid by the County significantly exceeded the actual cost of service.

The CFR, Part 92.40 (a) requires monitoring by the grantor (Luzerne County), which would include a review and analysis of independent audit reports for the providers of service. Audits, when utilized effectively, provide an additional monitoring tool to ensure that costs appear fair and reasonable and that funds were spent in compliance with contract terms. PACC's own independent audit report for the period ending December 31, 2003 similarly shows a \$1.2 million profit. The Department and the County officials responsible for reviewing the rates should consider PACC's financial data from 2003 (and any available subsequent data) when making determinations regarding the reasonableness of the contract between Luzerne County and PACC.

Results of Fieldwork (Continued)**Daily Rates in Excess of Actual Costs**

Excluding a start-up period, the PACC per diems charged to Luzerne County exceed actual costs by an average of \$85 per day for detention services and \$109 per day for treatment services. This has allowed PACC to generate a \$1.2 million profit for calendar year 2003 with a projected \$1.9 million profit for calendar year 2004.

According to PACC officials, the basis used to establish the per diems considered a market analysis of similar facilities and other factors such as risk and profit. The standard practice followed for other similar facilities, however, is to establish per diems based on historical actual cost and occupancy data.

The chart presented below shows the variance between the per diems included in the County contracts and actual costs incurred by PACC. The February through June 2003 period was a start-up period not representative of future periods. The compilation of the January through December 2004 actual per diems includes assumptions based on prior period data.²

<u>DETENTION</u>			
<u>Period</u>	<u>Per Diem</u>	<u>Actual</u>	<u>Variance</u>
Jan-June 03	\$268	\$239	\$29
July-Dec 03	\$268	\$186	\$82
Jan-June 04	\$280	\$196	\$84
July-Dec 04	\$290	\$200	\$90

<u>TREATMENT</u>			
<u>Period</u>	<u>Per Diem</u>	<u>Actual</u>	<u>Variance</u>
Jan-June 03	\$300	\$243	\$57
July-Dec 03	\$300	\$187	\$113
Jan-June 04	\$312	\$207	\$105
July-Dec 04	\$322	\$213	\$109

That notwithstanding, a comparison of the average detention per diem rates for Luzerne County and its surrounding counties shows that PACC per diem rates exceeded the average for this region by 40 percent in SFY03-04 and 42 percent in SFY04-05. Further, if per diem rates associated with PACC are excluded from Luzerne County per

² Our analysis entailed examining the actual costs incurred for the programs and the actual units of service provided. Documentation pertaining to the general and administrative expenses, including building costs was requested from PACC. However, PACC stated the information was "proprietary" and we were denied access to this documentation. As a result, the administrative and building costs included in the PACC calendar 2003 certified audit were used without review of the supporting documentation. The actual per diems listed in the above chart for calendar 2004 were developed based on the assumptions detailed in Exhibit A of this report.

Results of Fieldwork (Continued)

diem rates during SFY03-04, the average rate in Luzerne County falls from \$255.05 to \$178.53 – a rate that is consistent with the average for this region of \$187.79. Similarly, excluding per diem rates associated with PACC from Luzerne County, per diems in SFY04-05 reduces the average rate from \$281.49 to \$187.10, a rate consistent with the average of this region of \$195.29. The following tables of detention per diem rates demonstrate these differences.

County	2003-04	2004-05
Luzerne	255.05	281.49
Lackawanna	152.73	226.53
Monroe	188.51	210.43
Lehigh	195.98	200.15
Carbon	189.85	210.48
Schuylkill	187.70	192.40
Columbia	180.31	188.51
Sullivan	160.57	167.00
Northampton	263.20	198.09
Wyoming	180.59	172.30
Average	195.45	204.74
PACC Rate	274.00	290.00
% Difference PACC Rate vs. Average	40	42

	Luzerne County Average Rate w/ PACC Per Diems	Luzerne County Average Rate w/o PACC Per Diems	% Decrease Excluding Rates Associated with PACC
SFY03-04	255.05	178.53	30%
SFY04-05	281.49	187.10	34%

Based upon the above information, it is the BFO contention that the detention per diem rates included in the contracts between PACC and Luzerne County are not fair and reasonable.

Non-Allowable Costs

Costs in the amount of \$7,154 associated with a teacher providing education services during the period February through May 2003, were removed from consideration in our calculation of the 2003 detention per diem. Per Chapter 3170 regulations, education services are not included as a cost eligible for DPW financial participation. Additionally, our analysis identified direct care staff of the detention program who also worked in the education program who did not consistently report hours worked in each program. As a result we could not accurately allocate the cost of these two employees between the

Results of Fieldwork (Continued)

two programs and the costs remained with the detention program. The PACC assistant director acknowledged staff who work in both programs do not consistently record their hours worked in each program.

TANF Invoices Include Ineligible Medical Costs

Luzerne County billed and received TANF reimbursement for ineligible medical expenses incurred at the PACC facility. These medical expenses are associated with a contract between NHS and Prime Care Medical, Inc. for medical management and staffing services provided at PACC. The PACC per diems included in the Luzerne County agreements include medical costs. Per the County's TANF invoice, the entire per diem costs are being claimed for federal reimbursement. Our audit did not extend to identifying the amount of the ineligible medical costs.

The requirements of the U.S. Department of Health and Human Services, "Guide on Funding Services for Children and Families through the TANF Program", include a general prohibition, "...on expending federal TANF funds on medical services..." In addition, the OCYF Bulletin 3140-04-06, issued May 17, 2004, state, "Medical costs must be removed from the juvenile detention center per diem rate prior to billing to TANF." Since Luzerne County did not adhere to the applicable federal and Commonwealth regulations, they were incorrectly reimbursed for medical costs with federal monies.

Transfer of the Facility Operation to Luzerne County Will Require Reimbursement Based on Actual Costs

Effective January 1, 2005, Luzerne County entered into a lease agreement with PACC to lease the facility and assume responsibility for operation of the detention and treatment programs. As a County operated facility, the County is subject to the fiscal policies outlined in the Title 55, Chapter 3170 regulations, "Allowable Costs and Procedures for County Children and Youth Social Service Programs". Specifically, regulation 3170.11 (c) which identifies the sections of the 3170 regulations containing the policies for claiming DPW participation for services provided through County operated facilities. For these facilities, reimbursement is based on and cannot exceed actual costs.

It is the BFO's understanding that Luzerne County officials, as part of their negotiation of the financial terms of the PACC lease, anticipated the County would generate profits by selling empty beds to other counties. However, the 3170 regulations limit DPW financial participation for county operated facilities to the actual costs of the facility, which does not allow for profit. Any revenue from the sale of beds must be used to reduce the costs of the facility. Specifically, Chapter 3170.23 (d) (2) allows program funding of total eligible expenditures of a facility provided the cost of the service is

Results of Fieldwork (Continued)

reasonable and the cost when computed on a per diem basis does not exceed actual cost.

A decision by the County to sell empty beds to other Pennsylvania counties is subject to compliance with Chapter 3170.84 (a) (2) which would require the County to sell the beds based on the actual allowable costs incurred by the County as reported per the quarterly reports to the DPW. The OCYF may wish to grant a waiver of the Chapter 3170.84 requirement to allow the sale of unused beds to other counties at one rate throughout the year, provided the rate does not exceed actual costs. The rate agreed upon should as best possible represent actual allowable costs.

Recommendations

The BFO recommends that OCYF take all appropriate steps to ensure Luzerne County adheres to the Chapter 3170 regulations as required for county operated facilities.

The BFO recommends that the Department oversee completion of a cost analysis as required by the Code of Federal Regulation. The analysis should limit the allowance for profit to an amount that would not exceed 10% of revenue.

The BFO further recommends that the Luzerne County C&Y revise its federal and state funding claims for the period January 2003 through December 2004 to reflect the following:

- The findings and results of the cost analysis completed by the Department.
- Luzerne County C&Y should then determine if allowable TANF expenses were incurred during the same period for other TANF reimbursable services such as In-Home and Emergency Shelter program that were not funded with TANF funds due to the TANF allocation being exceeded. If this determination discloses that expenses were incurred, the County C&Y agency can substitute these expenses for the unallowable detention expenses, otherwise the associated federal funds must be returned.

The BFO also recommends the OCYF require Luzerne County to perform sub-recipient monitoring of all applicable grants and contracts. This would include effectively negotiating rates of all contracted providers utilizing a cost/price analysis and a "fair and reasonable" profit factor. The basis for the negotiations should be the standard computation using the actual cost of service divided by the days of service. Effectively negotiating rates would free up state and TANF funding, reducing the amount of County funds required to provide services.

The BFO also recommends the OCYF determine the most practical method for Luzerne County to report actual allowable costs for the TANF and Act 148 reimbursement going back to the January 2005 quarter. One method is for the County to complete a

Results of Fieldwork (Continued)

quarterly reconciliation to actual costs, which would result in a different per diem each quarter.

In the future, other counties would reimburse Luzerne County based upon an annual contracted per diem, which for existing programs would be developed using previous year actual costs and units of service. The income from this arrangement would be used to reduce the actual quarterly costs in the invoicing to DPW. Luzerne County could use a budgeted per diem based on anticipated costs and units until actual costs are available.

The BFO further recommends Luzerne County discontinue the practice of billing TANF for medical costs. This would result in the County reporting medical costs on the CY 348 for Act 148 reimbursement. The medical costs funded through Act 148 must be limited to those costs not reimbursable through MA or for MA ineligible placements.

The BFO finally recommends that Luzerne County instruct their contracted managing entity to accurately record the time and cost of direct care staff who also work in the education program.

Issue No. 2 The 2005 Lease Between PACC and Luzerne County Appears to be a Capital Lease

Effective January 1, 2005, Luzerne County entered into a 20-year lease agreement with PACC to lease the PACC juvenile care facility and assumed responsibility for operation of the detention and treatment programs. The terms of the lease require a minimum monthly rental of \$193,333.33 for the first year based on the existing 48-bed facility.

The first year payments total \$2.3 million. The minimum rent payments over the 20-year lease total \$46.4 million. The minimum payments could increase to \$58 million depending on the completion date of the proposed 12-bed expansion.

Luzerne County receives reimbursement for C&Y service expenditures through a variety of federal and state sources. Prior to January 1, 2006, most detention expenses are reimbursed 100 percent through the federal TANF program. The receipt of federal funds subjects the County to the requirements of the Code of Federal Regulations. As such, the PACC rental costs are subject to the limitations of OMB Circular A-87.

Requirements of OMB Circular A-87 Related to Rental Costs

A capital lease is a lease that transfers substantially all the benefits and risks inherent in the ownership of a property to the lessee. OMB A-87, Attachment B, Section 38(d) Rental Costs, states, "Rental costs under leases which are required to be treated as capital leases under GAAP are allowable only up to the amount that would be allowed had the government unit purchased the property on the date the lease agreement was

Results of Fieldwork (Continued)

executed. This amount would include expenses such as depreciation or use allowance, maintenance and insurance.”

Section 38(d) also identifies criteria for a capital lease. “The provisions of Financial Accounting Standards Board Statement 13 shall be used to determine whether a lease is a capital lease.” The lease would be classified as a capital lease if “the present value of the minimum lease payments at the beginning of the lease term is 90 percent or more of the fair value of the property at the inception of the lease.”

County Needs to Document Fair Value of PACC Property

Luzerne County needs to obtain and document the fair value of the PACC property in order to determine how much of the lease payments are eligible for reimbursement. Based on available information, it appears that the PACC lease meets the requirements of a capital lease. The present value of the \$46.4 million minimum lease payments for the 48-bed facility is \$26.6 million. The fair value of the property would have to exceed \$29.5 million before the lease could be classified as anything other than a capital lease. Considering the original cost basis of the property including furniture and equipment is \$8.9 million, as reported in the PACC independent CPA audit, it is unlikely fair value of the facility would exceed the \$29.5 million identified above.

County Needs to Document PACC Building Costs

Should the Department determine that the PACC lease does meet the definition of a capital lease, the County will need to obtain and document the actual building costs of the PACC facility in order to determine the rental costs eligible for federal reimbursement. Section 38(d) of OMB Circular A-87 allows rental costs “only up to the amount that would be allowed had the governmental unit purchased the property on the date the lease agreement was executed”.

Unallowable Rental Costs

The costs included in the PACC calendar 2003 independent CPA audit specifically related to the building are \$686,333. The \$686,333 is comprised of \$339,532 for depreciation and \$346,801 for interest.³ As such, the \$1,633,667 difference between the \$2,320,000 annual lease payments and the actual building costs of \$686,333 would be considered an unallowable cost under federal regulations. Based on the actual units of service provided by PACC for the 12-month period ended June 30, 2004, we project 16,862 units of detention and secure treatment services will be provided during calendar year 2005. The \$1,633,667 of unallowable rental costs divided by the 16,862 projected units results in \$96.88 of the daily per diem being unallowable for federal and state reimbursement.

³ The BFO was unable to determine if the depreciation and interest costs represented a full 12 months.

Results of Fieldwork (Continued)

State Funding of PACC Lease Rental Costs

The PACC rental costs determined unallowable under federal cost guidelines also appear to be unallowable for state reimbursement based on application of the Pennsylvania Code Title 55, Chapter 3170 regulations. These regulations define the costs allowable for reimbursement using Commonwealth Act 148 funds.

Specifically, 3170.11 states "the Department will participate financially in the payment of those expenditures which are necessary and justifiable for program operation."
"Expenditures made by the county children and youth program shall be reasonable to the extent that they are of the same nature as expenditures which would be made by a prudent buyer in the market place." Additionally, the limitations of 3170.52(c) must be considered. This regulation applies to mortgaged real estate which is owned by a County and charged as a rent expense. Specifically, 3170.52(c)(1)(2) states rental charges "shall be the lesser of the fair rental value of the space or the actual cost of principal and interest".

Based on the information provided, the BFO does not believe the \$2.3 million payment for annual rental costs meets the definition of "reasonable" as it significantly exceeds the \$686,333 cost of depreciation and interest.

Recommendations

Based on the above available information, the BFO concludes the PACC lease meets the requirements of a capital lease. This will require OCYF to make appropriate changes to State Act 148 funding of that lease and require Luzerne County to obtain and document the fair value and actual building costs of the PACC facility in order to determine the actual amount of reimbursable rent. The documentation used to determine allowable rental costs must be made available upon request for review by authorized representatives of the state and federal government.

Otherwise, in lieu of receipt of documentation, the OCYF should consider \$1,633,667 as the unallowable rental costs based on the original 48 bed facility. At the time, annual leases payments increase to 2.9 million based on the 12 bed addition, unallowable rent should be increased to \$2,042,093. The BFO also recommends that the federal TANF claims submitted by the County for detention services be adjusted to eliminate any unallowable rental costs.

Issue No. 3 Contract Provisions between Luzerne and PACC May Have Contributed to Potentially Inappropriate Billings from PACC

Results of Fieldwork (Continued)

Luzerne County Used A Non Standard Placement Agreement To Contract With PACC

The terms of the PACC placement agreement include significant differences from the standard purchase of service agreement used by the County for all other providers. The differences extend to payment terms, audit requirements, maintenance of records and insurance requirements. The use of the non-standard agreement for PACC has adversely affected the ability of the County and DPW to effectively review financial records and monitor the fiscal operations of PACC. The payment terms of the PACC agreement may have also contributed to inappropriate payments being made to PACC for billing of discharge days. Additionally, the modifications and/or exclusions in the PACC agreement does not provide full compliance with the requirements of Chapter 3170.93(e) – service contracts or agreements, which requires that purchased service contracts contain provisions for the maintenance and retention of accounting records, audit and inspection rights for the County and Department, and a budget and fiscal statement of how fees or costs were determined. The reason that a “custom” contract was used to formalize the agreement between PACC and Luzerne County could not be determined. According to Juvenile Probation Office officials, their office was not involved in review of and approval of the PACC placement agreement. As a result, we could not determine who would have reviewed the contract if a review was conducted.

Differences in PACC Placement Agreement and Standard Purchase of Service Agreement

The following are examples of differences between the PACC placement agreement and the standard purchase of service agreement used by the County.

- Lack of Audit Rights: The standard agreement used by the County provides four pages of comprehensive audit requirements. These requirements, in part, include audit rights and access to CPA audit workpapers by federal, state and local agencies, remedies for non-compliance with audit requirements, and preparation of a corrective action plan to address findings of non-compliance and internal control weaknesses. The PACC agreement is primarily limited to a general statement requiring compliance with federal and state audit requirements and financial reporting requirements. The PACC agreement does not include any of the specific requirements that are referenced above.

A request to meet with and have full access to the PACC audit firm workpapers was made by the BFO but denied by PACC. Having full access to the CPA workpapers as would be allowed per the terms of the County standard agreement would have provided the information necessary to understand the nature of certain costs including that of the certified audit. The workpapers could also provide resource for documentation of building and administrative and general expenses included in the PACC audit. The documentation for these expenses was denied by PACC as they considered the information to be proprietary.

Results of Fieldwork (Continued)

- **Non-Standard Payment Terms:** The PACC agreement and the County standard purchase of service agreement both include a payment term that allows payment for the "first and all subsequent days of care". The standard agreement used to contract with NHS Youth Services includes a modification of this term with payment made for the "first and all subsequent days of care except the day of discharge". Our review determined with the exception of PACC, the practice followed by the County C&Y and JPO offices for all other service providers is to make payment for only the day of admission and not the day of discharge.

For the period February 2003 through June 2004, the County Programs paid PACC \$287,608 for units representing the day of discharge. For the period July through December 2004, an additional \$117,028 was projected to be billed by and paid to PACC representing the day of discharge. The total payments for the day of discharge total \$404,636. The total was comprised of \$391,272 for detention services and \$13,364 for secure treatment services. Luzerne County's share of these payments was approximately \$400,590. For the period January 2003 through December 2004, Luzerne County included \$387,359 of expenditures representing the payment of detention discharge days on their federal TANF claims.

The payment for day of discharge does not appear to be consistent with several components of the Pennsylvania Code, Chapter 3170. Section 3170.11(b) which limits the Department's financial participation to "the payment of those expenditures which are necessary and justifiable for program operation" also advises that "expenditures made by the county children and youth program shall be reasonable to the extent that they are of the same nature as expenditures which would be made by a prudent buyer in the market place". Additionally, Section 3170.85 states that the "appropriate county authorities are responsible to obtain the best possible rate for services by the county children and youth agency". Additionally, general industry practice is to make payment for the day of admission but not the day of discharge. This is the practice followed by the Luzerne County C&Y and JPO for all service providers except for PACC.

Included in the discharge days are days related to the internal transfer of a juvenile from the PACC detention to the PACC treatment program. In these instances, juveniles located in the PACC detention facility were transferred by order of the judge to the secure treatment unit in the same facility. In these cases the PACC charges the County for both discharge from the detention program and the day of admission to the treatment program, even though it occurs on the same day. In this situation, Luzerne County reimbursed PACC \$568 for a single day of service (\$268 for detention services and \$300 for secure treatment).

Results of Fieldwork (Continued)

- Lack of Insurance Coverage: The standard purchase of service agreement has requirements for automobile and professional liability insurance coverage and maintenance and retention of records and reports. These requirements are not in the PACC agreement.

Recommendations

The BFO recommends the OCYF require Luzerne County to ensure the standard purchase of service agreement is used for all service providers. This will provide compliance with the requirements of Chapter 3170.93(e) – service contracts and allow federal, state, and local agencies full access to all financial and audit records needed in order to provide effective financial monitoring and oversight.

The BFO also recommends that the OCYF require Luzerne County to revise existing and/or future contracts to ensure a provider is only reimbursed for the usual and customary days of service, which would only be the day of admission.

The BFO further recommends the OCYF inform Luzerne County to revise its federal and state funding claims to reflect the following:

- The federal TANF claims for detention service costs should not include the \$387,359 representing the expenditures incurred for day of discharge.
- Luzerne County C&Y should then determine if allowable TANF expenses were incurred during the same period for other TANF reimbursable services such as In-Home and Emergency Shelter program that were not funded with TANF funds due to the TANF allocation being exceeded. If this determination discloses that expenses were incurred, the County C&Y agency can substitute these expenses for the unallowable detention expenses, otherwise the associated federal funds must be returned.

The BFO finally recommends that the OCYF initiate a review of the Fiscal Year 2003-04 and the Fiscal Year 2004-05 to ensure that state funds were not used to fund the \$400,590 of expenditures incurred for payment of day of discharge for both detention and secure treatment services. This amount includes payments of \$284,732 for the period February 2003 through June 2004, and \$115,858 for the period July-December 2004.

Results of Fieldwork (Continued)**Issue No. 4 The U.S. Department of Agriculture's National School Lunch Program Appears to have been Over-Billed by \$11,472.51**

While operating PACC's Juvenile Detention Center, NHS violated Federal Department of Agriculture (DOA) regulations by submitting and receiving reimbursement for staff meals. NHS over billed and received \$11,472.51 from the Pennsylvania Department of Education (PDE) for staff meals billed for the period March 1, 2003 through June 30, 2004. PACC financially benefited from the over billing. Since the PACC bills the county programs based on a fixed per diem, the additional food revenues resulted in a reduction to PACC operating costs and an increase to profit.

The National School Lunch Program is governed by DOA regulations. Regulation 7 CFR 210.2 defines reimbursement as "Federal cash assistance to schools for lunches meeting the requirements of 210.10 and served to eligible children". This regulation prohibits individuals other than eligible children from participating in the program. The PDE National School Lunch Program administrator provided confirmation that staff meals are ineligible for reimbursement.

Recommendations

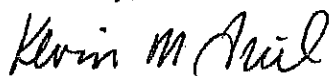
The BFO recommends the OCYF inform the NHS that staff meals are ineligible for reimbursement, and recommend the NHS stop the practice of billing for staff meals. The OCYF should also recommend NHS refund the PDE for the reimbursement received for staff meals billed for the PACC and for any other programs operated by the NHS for which staff meals were billed.

The BFO also recommends the NHS monthly reports of meals be prepared by calendar month instead of a four-week period to provide for a more accurate monthly claim and ensure all eligible meals are being claimed for reimbursement.

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

Please contact Tina Long, Audit Resolution Section, at (717) 705-2288 if you have any questions concerning this matter.

Sincerely,



Kevin M. Friel

Attachment

cc: Mr. Robert Powell
Mr. Frank J. Castano
The Honorable Maryanne Petrilla
The Honorable Gregory Skrepenak
The Honorable Stephen Urban
Mr. Gregory R. Zapalla, Esquire
Mr. Jonathan Vipond, Esquire
Mr. Geoffrey R. Johnson, Esquire

EXHIBIT

Due to a scope impairment by PACC to restrict access to certain records considered "proprietary", the following assumptions were used in compiling the January through December 2004 actual per diems detailed in Issue No. 2.

- For the period January through June 2004, the operating cost component is representative of actual costs posted in the PACC financial records. These costs were increased by four percent to establish the July through December 2004 costs.
- The administrative and building cost component is representative of the like expenses included in the PACC calendar 2003 certified audit, plus the projected 12-month costs of the new PACC business manager position established in late calendar 2003.
- The miscellaneous income used to establish the net actual costs was based on annualizing the income received from the National School Lunch Program and various school districts for the period July through December 2003 when the program was operating at near full capacity.
- The census data used to establish the per diems is based on actual billed units for January through June 2004, with July through December 2004 based on an average of units billed for the period July 2003 through June 2004.

SUBSEQUENT EVENTS AND AUDITOR'S COMMENTARY

The Department provided a copy of the draft audit to the Luzerne County Children and Youth Program and PACC in February 2007. PACC provided a written response in March 2007. After reviewing the response, the Department informed the Luzerne County and PACC representatives that the DPW would conduct a "cold reader" review of the draft audit by DPW personnel independent of those involved in the audit field work and report writing and make any changes appropriate to the draft as a result of the review.

When the review was completed, a revised draft audit was issued on September 25, 2007. In lieu of a formal audit exit conference, the Department held several meetings with both Luzerne County and PACC. The responses submitted from both Luzerne County and PACC have been attached and are incorporated in the final audit as appendices of this report. The BFO's review of the responses identified several areas that warrant clarification in the following auditor's commentary.

Omitted Documents and Information

In accordance with Government Auditing Standards we are required to report on information that was omitted from this report and the effect of the omission. PACC provided the BFO with a copy of pro-forma financial statements for 2003 and a certified audit of 2004 as part of their responses. PACC requested that the documents be kept confidential and they are not included in the report but will be provided to the Office of Children, Youth and Families under separate cover. The omitted documents adversely affect the reader's ability to understand how funds were expended and include information that is inconsistent with PACC's position or response to several audit findings.

AUDITOR'S COMMENTARY

Luzerne County Response

The County chose to not contest any of the audit findings directly and instead provided only a general response. Auditor's commentary regarding several issues raised in the County's response is provided below.

The County asserts that the lease with PACC was its best and only option

- The lease, in its present form, was not the sole and best option for the county as several other options existed. By way of example, the approximately \$2.9 million that the County pays to PACC in annual lease payments could have instead been used as debt service for the borrowing of enough funds to construct and furnish at least three detention facilities. Proceeding in this manner would have also allowed the County to own the facility instead of merely leasing it from PACC. In addition to constructing its own facility, there were several other options available to the County including the use of other facilities in neighboring counties.

The County asserts that detention and secure residential costs were reduced as a result of the lease

- The Department made requests to both Luzerne County and PACC to provide any detailed information in the form of cost schedules, contracts or other appropriate documents to verify this claim. Despite these requests, the Department never received documentation supporting this assertion. The assertions of savings in the responses from both Luzerne County and PACC provide no detail to support the claim.

The County asserts that it is better to serve children close to home

- The Department agrees that it is best to place children as close to home as possible. The decision, however, must be made in conjunction with other factors such as the cost of those services and the availability of other feasible options.
- Despite the position stated in its response, Luzerne County has utilized facilities both close to home and others that are at a distance. Of specific note, the County purchased in excess of one million dollars in services during FY 06-07 from a facility operated by PACC, located in Butler County – more than 236 miles from Wilkes Barre, despite the availability of facilities that are geographically much closer to Luzerne County.

PACC Responses

PACC asserts that the audit is unbalanced and factually incorrect. To support this assertion, PACC provided the Department with some additional financial statements that purported to show additional costs that were not available to auditors during the Department's initial fieldwork.

After reviewing these documents, the BFO found PACC's position could not be credibly supported by the information provided. While BFO will not comment further at this time due to PACC's assertion that this information is proprietary and confidential, the Department believes that the BFO audit report accurately represents PACC's financial arrangement with the County.

Officials representing PACC provided the DPW with three separate responses as part of the audit process. Commentary related to these responses is provided below.

PACC Asserts that its Lease is Not a Capital Lease

- The BFO believes that the analysis provided in the audit report is sufficient to show that the lease is in fact a capital lease. This contention is somewhat surprising since PACC's Chief Financial Officer stated that the lease was a capital lease in a meeting with the Department in October 2007.

PACC Disputes Amount of Profit for 2003 and 2004

- The response asserts that "BFO made an early and undocumented determination that PACC made a profit of \$1.2 million and had additionally distributed dividends of \$2 million to members." The response continues that BFO did not "have full information as to all of the detailed operating costs of PACC including debt service, administrative costs, insurance costs, taxes, maintenance costs, initial development costs, construction management costs, capitalized interest and other risk related costs incurred for the start-up of new facility in early 2003".

Subsequent to the completion of fieldwork, PACC did provide the Department a pro-forma financial presentation for 2003 and a 2004 independent CPA audit. BFO found the amounts and classifications of certain costs in both documents to be inappropriate. The BFO believes these costs as presented were unreasonable and others should properly have been classified as profit or return to ownership. Due to PACC's request to keep these documents confidential, BFO will not comment further on these claims at this time.

PACC asserts that its Lease with the County has allowed the County to Realize Substantial Savings

- The Department was unable to validate this assertion. As noted in the auditor's commentary on the Luzerne County response, neither PACC nor the County has provided any detailed information to support this assertion.

PACC Asserts That The County Did Not Fail to Negotiate its Contract

- BFO has not been provided nor has it uncovered any evidence that the County completed the required cost analysis prior to entering into an agreement with PACC and PACC has not provided any evidence other than its assertions that such a cost analysis was completed.

PACC Asserts That it Did Not Improperly Invoice For Both the Day of Admission and Discharge

- We agree that PACC's billings were in accordance with their purchase of service agreement with the County. This agreement, however, was unique to PACC. A review of the standard Luzerne County Juvenile Probation Purchase of Service Agreement provides for payment of the per diem rates "for the first and all subsequent days of care except the day of discharge." Neither the County nor PACC has provided a rationale for why the standard contract language was not used.

PACC is unaware of a standard purchase of service agreement

- While all other providers were required to utilize the County standard contract, County officials allowed PACC to develop their own contract. The PACC contract did not provide all of the requirements and safeguards of the standard contract and should have not been used.

Luzerne County
Response to Draft Report

LUZERNE COUNTY COMMISSIONERS
GREGORY A. SKREPENAK, CHAIRMAN
ROSE S. TUCKER
STEPHEN A. URBAN

JAMES P. BLAUM, ESQ.
County Solicitor



FRANK J. CASTANO
DIRECTOR

SAMUEL T. GUESTO, JR.
County Manager for Legislation and
Chief Clerk

LUZERNE COUNTY
CHILDREN AND YOUTH SERVICES

111 North Pennsylvania Boulevard, Suite 110, Wilkes-Barre, PA 18701-3697
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TDD (570) 825-1860

December 24, 2007

Mr. Kevin Friel, Director
Bureau of Financial Operations
PA Department of Public Welfare
3rd Floor Bertolino Building
P.O. Box 2675
Harrisburg, Pennsylvania 17105-2675

Dear Mr. Friel,

As per your request on December 10, 2007, this letter is to serve as a response to the draft audit relative to the lease between PA Child Care, LLC ("PACC") and Luzerne County (the "County") of the juvenile detention facility located in Pittston Township.

As you are aware, I was not the Director of Luzerne County Children and Youth Services at the time the County entered into the lease with PACC. Through my review with County officials, I have been informed that the lease with PACC was the best and perhaps the only option then available to keep the children close to their families to best promote and facilitate timely reunification.

Although the Bureau of Financial Operations ("BFO") has identified concerns regarding the lease, the County has shared with BFO during the numerous teleconferences that have occurred during the last three (3) months that, in the last three (3) fiscal years the County has reduced costs for juvenile detention and secure residential services. Moreover, it cannot be disputed, that placing Luzerne County juveniles in close proximity to their homes has been in the best interests of those children and their families due, in part, to the fact that it makes possible the implementation of treatment plans that can more easily include the participation of the juvenile's family members.

As was also discussed in the numerous conversations between the County and BFO, the overall costs of services at the subject facility is in many cases less than the costs that would be incurred if the County were forced to use facilities out of the area. As BFO is aware, this facility is utilized by other counties of this Commonwealth and,



Exhibit A
Page 1 of 3

as far as this County is aware, BFO has not questioned the costs being incurred by those counties in placing their juveniles at the facility. It is the County's understanding from its discussions with BFO that the crux of BFO's concerns is not with the overall costs being expended by the County or with recouping any funds expended to date but rather with the fact that part of the funds being expended goes toward the current lease with PACC. BFO has made it clear that the County could face reimbursement and funding implications that would total in the several millions of dollars if BFO's concerns with respect to this lease are not resolved to BFO's satisfaction.

In order to find a resolution to the draft audit, BFO provided the County with guidance and then directed the County to enter into negotiations with PACC. The result of the negotiations between PACC and the County produced the offer of a mutually agreeable termination of the lease. This was discussed during a conference call on December 10, 2007 between BFO and the County and, at that time, the proposed solution of terminating the lease was not accepted by BFO. As set forth above, the County believes that the lease has been beneficial to the County. However, despite the benefits that the County saw and continues to see in leasing this facility, the County would certainly terminate the lease as soon as BFO approves such an action in order to resolve this matter. Since the lease is the focus of BFO's concerns, the termination of the lease should fully and finally address all of the concerns outlined in the draft audit and the County respectfully requests that BFO give this proposed solution further consideration.

If the lease is terminated, the County is concerned about the limited availability to the County of detention services and the prospects of the Court having to make detention placements where juveniles of the County are scattered among numerous facilities, many of which will require transportation between the Court and facilities in far away locations. The concern, obviously, is that the potential transportation costs and labor costs (including overtime) will create a financial hardship on the County. While the County is willing to undertake any actions that BFO deems appropriate so as to resolve this audit, the County respectfully requests that BFO consider a possible scenario where the lease is terminated but where the County reserves twelve (12) spaces at the PACC facility on an ongoing basis for the Court's detention needs. This could be a relatively short term arrangement while the County explores the prospects of building its own detention facility. The County is simply concerned that, if and when the lease is terminated, the PACC facility will most likely be converted by PACC to a facility solely dedicated to secure residential services and that the County will be left with unsatisfactory detention options in remote locations while other counties of the Commonwealth enjoy the use of a facility that is located in this County.

It is the County's interest to find alternative placement options for all future children if and when the lease is terminated with PACC. It is also the County's interest to ensure that the children currently placed at the facility remain there until their discharge from the program so as not to disrupt their treatment. If the lease is terminated, the County will make every effort to find alternative placement options as close to Luzerne County as possible to best serve the needs of the children and their families. However, that goal would be much more likely to be attained if the County could secure the usage of a portion of the PACC facility for detention services. The County is looking for further guidance from BFO as to a course of action that will both satisfy BFO and spare the taxpayers and the County's court system from undue hardships that were at the front of mind of the County at the time it entered into this lease.

Your consideration of the foregoing is greatly appreciated. I have given careful attention to this matter and I will continue to work with BFO and County officials to find a resolution.

Sincerely,



Frank J. Castano
Director
Luzerne County Children and Youth Services

CC: Commissioner Gregory Skrepenak
Commissioner Rose Tucker
Commissioner Stephen Urban
Commissioner Elect Maryanne Petrilla
Mr. Samuel Guesto
Mr. Samuel Diaz
Mr. Brian Bufalino
Mr. Joseph DeVizia
Honorable Mark Ciavarella
Mr. Larry Saba
Mr. John Johnson

PA Child Care, LLC
Responses to Draft Report

Exhibit B March 8, 2007
Exhibit C October 26, 2007
Exhibit D November 5, 2007

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March 8, 2007

VIA HAND DELIVERY

Ms. BethAnn Smetak
Acting Deputy Secretary
Office of Children, Youth & Families
Department of Public Welfare
131 Health & Welfare Building
Harrisburg, PA 17120

RE: Response to Bureau of Financial Operations "Draft" Audit Report
PA ChildCare, LLC, Dated February 6, 2007

Dear Ms. Smetack:

My client, PA ChildCare, LLC ("PACC"), is in receipt of a February 6, 2007 "draft" Audit Report prepared under the direction of John H. Bungo, Director of the Bureau of Financial Operations ("BFO") at the Department of Public Welfare ("Department"). We note that the original audit activities which resulted in this report occurred in October and November 2004 and that BFO work papers were released to the public, leading PACC to seek injunctive relief in the Court of Common Pleas of Luzerne County, which relief was granted. We also note subsequent efforts of PACC counsel to negotiate with the Department's counsel and the Office of the Attorney General an appropriate and balanced Audit Report to correct a multitude of inaccuracies in the original draft Audit Report and to provide additional documentation as to the fairness and benefit to Luzerne County of the development of a new juvenile detention facility for the county in 2003. I urge you, and the Secretary of Public Welfare, not to issue this Audit Report as presently drafted as it is replete with inaccurate factual statements, faulty financial analyses based on concededly-incomplete information and, therefore, unsupportable conclusions.

We are providing this response and analysis as allowed and requested in Mr. Bungo's February 6, 2007 letter as part of our ongoing efforts to resolve the questions raised by the BFO

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auditors and to present a fair and unbiased description of the contractual relationships between PACC and Luzerne County, first under a contract for secure juvenile treatment and detention services in 2003 and 2004, and then under a long term lease with Luzerne County for the facility as on January 1, 2005. The Audit Report should either be withheld completely in its present form or substantially and extensively amended as we have been endeavoring to do since late 2004. Accordingly, PACC now formally responds in writing to the February 6, 2007 "draft" Audit Report and herein states its detailed objections.

INTRODUCTION

As noted above, the saga of the audit process by BFO has been fraught with dispute and controversy from the outset. It is PACC's position that much of this conflict has resulted from mistaken stances taken at the outset of the process and the refusal to adjust those stances through negotiation. As the parties have grown rooted in steadfast and adverse positions, the ability to listen, the ability to communicate and to objectively reflect has been lost. Such a scenario usually results in the dedication of an inordinate amount of resources to conflict rather than resolving the initial misunderstanding. Former Israeli Army General Moshe Dayan once said "If you want to make peace, you don't talk to your friends, you talk to your enemies." The Greek philosopher Aristophanes stated: "A man can learn wisdom even from a foe." It is respectfully suggested that the issues separating the parties herein can be resolved if both sides heed this sage advice.

The matter at hand is the BFO "draft" Audit Report as to the operations of the juvenile detention facility in Pittston, Luzerne County. The Audit Report has from its earliest drafts erroneously described an operation generating excessive profits ultimately paid for by the taxpayers of Luzerne County, the Commonwealth of Pennsylvania and to an extent the United States of America as county, state and federal funds all support juvenile detention services.

From the time of the initial audit activities in the fall of 2004, PACC has cooperated with BFO personnel, but has steadfastly maintained that the information relied upon in the various versions of the Audit Report is incomplete, the analysis flawed and the conclusions unsupported. The core dispute between the parties-- PACC and the Department -- concerns the incomplete nature of the financial analysis conducted by BFO. BFO in the Audit Report acknowledges that the "scope of our audit was limited," February 6, 2007 Audit Report at 3, and that, therefore, its conclusions are based on incomplete information, *id.*, an incomplete audit process, *id.* at 4, and an inability to determine the fair value of the PACC property. *Id.* at 11. There is substantial essential and relevant information that is absent from the Department's Audit Report -- information that both parties must agree to include if an accurate, properly analyzed and, most importantly, fair report is to be issued.

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The parties agree that more information could impact the audit findings. The dispute as to the provision of such information by PACC arose out of the Department's expressed willingness and need to review such information as part of its audit process and PACC's expressed need to retain the confidentiality of such information as part of its proprietary internal business information. This inability of the parties to agree as to how to resolve this issue has escalated and complicated this process. PACC asserts that the Department through its Regional Office of Children, Youth and Families initiated inappropriate and baseless licensure enforcement proceedings to obtain such information and then permitted or did not prohibit certain BFO personnel from releasing information as to the preliminary audit findings to unauthorized third parties and ultimately to the press. PACC initiated trade secrets litigation in the Court of Common Pleas of Luzerne County against Departmental personnel involved in these actions in their individual capacities. PACC through counsel continued its efforts to provide the requisite information to the Department in a manner which would not compromise PACC's proprietary interests. Ultimately no agreement could be reached as to providing information in some protected fashion and negotiations ceased. The parties had sought to devise a means to secure the confidentiality of PACC's proprietary information and, absent such agreement as to protection, PACC was given the Hobson's Choice of disclosing its proprietary information or risking the publication of an inflammatory and flawed Audit Report.

PACC still seeks resolution of this dilemma by further negotiation with the Department.

HISTORY

A. Introduction and Background

Juvenile detention and treatment facilities in Pennsylvania, and particularly secure facilities for county services, are in short supply at a time when demand for such services is high and ever more important. In response to a specific need for such services in Luzerne County and a growing market emphasis on the provision of human services resources by private enterprise, PACC, a private, for-profit limited liability company ("LLC"), put its own capital at risk, negotiated through complex local and state regulatory barriers, and brought to market a state-of-the-art, model secure juvenile detention and treatment facility. The facility was promptly licensed by the Department in early 2003. The result was a new fully licensed and operational facility designed to accept for detention and treatment the least desirable adjudicated delinquents from Luzerne County and elsewhere.¹

It is important to recognize that PACC, and its sister corporation Western PA Child Care, LLC ("WPACC"), in developing new detention facility capacity in Pennsylvania have

¹PACC's recognized operational success as a secure juvenile detention and treatment facility has spawned a second facility serving a five county area in Western Pennsylvania, which facility enjoys similar operational success.

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endeavored to work harmoniously with the Department, and, in fact, has enjoyed a cordial relationship with respect to all licensing and regulatory matters. Indeed, PACC believes that the Department has encouraged its efforts and has commended the quality of its service delivery. PACC has therefore been distressed at the Department's perceived intransigence in not permitting reasonable resolution of the issues raised in the Audit Report and, without compromising the integrity of its proprietary business model and processes, seeks to end the dispute to the satisfaction of both parties and Luzerne County by demonstrating the fiscal and programmatic soundness of the negotiation process, the rates, and the remuneration to PACC in the context of the development of a completely new facility and the absence of viable competitive alternatives for detention services.

On December 31, 2002, the Court of Common Pleas of Luzerne County ordered the closing of the century-old Luzerne County Juvenile Detention Center ("Center"). The conditions at the Center included the following:

[R]odent [rats and other vermin] and cockroach infestation; roof leaks; inadequate physical disability accessibility; lack of facilities for physical examinations, classrooms and indoor physical education; and inadequate hot water, plumbing and ventilation. Due to a lack of air conditioning during the summer months, the windows had to be opened through which the detainees passed drugs and contraband. On December 6, 2002, President Judge Conahan, Juvenile Judge Ciavarella and other court officials held a meeting with Union officials regarding the closing of the Detention Center regarding the unsanitary conditions that threatened the health, safety and welfare of the juvenile detainees and increased the risk of liability.

See *AFSCME District Council 87 v. Luzerne County*, Case No. PERA-C-03-104-E, Final Order of the Pennsylvania Labor Relations Board, dated October 19, 2004, a copy of which is appended hereto as Exhibit "A." Conditions at the old Center were unquestionably dirty and dangerous, with those receiving services suffering abuse at the hands of other juveniles amid allegations that staff were indifferent to the health and safety of their charges. See *A.M. v. Luzerne County Juvenile Detention Center*, 372 F.3d 579 (3d Cir. 2004), a copy of which is appended hereto as Exhibit "B."

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B. The aging and dangerous Center was replaced by PACC's state-of-the-art facility.

Recognizing the need for new secure juvenile detention and treatment facilities in Luzerne County and elsewhere in Pennsylvania, two individuals, Robert Powell and Gregory Zappala, through their separate corporate entities, formed the limited liability company now known as PACC. Through the efforts of its two principals, PACC gained the necessary regulatory approvals, raised the necessary capital, and designed and constructed a state-of-the-art juvenile detention and treatment facility in Pittston, Luzerne County. The PACC facility featured licensed forty-eight (48) beds (later expanded to sixty (60) beds), health and medical facilities, educational facilities, psychiatric/therapy facilities, as well as recreational and social facilities. *See Exhibit "C"* Photographs of PACC Luzerne County facility and description of services. The PACC facility specializes in detention and treatment of the juveniles who are difficult to place in county facilities or other private facilities – juveniles requiring secure treatment and secure detention, as well as those requiring specialized treatment as sex offenders and "fire starters." Traditionally, juveniles requiring such specialized treatment must be transported to facilities hundreds, if not thousands of miles away – at a significantly higher cost to a county and ultimately the Commonwealth of Pennsylvania.

As noted above, the Department in early 2003 granted the PACC facility initial provisional and then full licensure. The PACC facility was inspected by Leonard Pocius, Northeast Regional Director of the Department's Office of Children Youth & Family and his staff. *See Exhibit "D"* Deposition of Leonard Pocius at 22-30. After such inspection, the Department issued PACC a provisional license for six months, and subsequently, after review, a full license. *Id.* at 30-31.

From the beginning of operations in February 2003, PACC contracted with Northwestern Health Services, Inc. ("Northwestern") to staff the PACC Center. Medical services were also contracted for with PrimeCare Medical, Inc. It is significant to note that the management contract between PACC and Northwestern was amended in January 2004 to shift the the accounting and billing functions to PACC.

As a newly formed and operating entity, PACC undertook to calculate a per diem for its secure detention and secure treatment services and to negotiate rates for services with Luzerne County. Two modalities were utilized to calculate the per diem. First, PACC, in its first year of operating a juvenile detention and treatment facility, asked Northwestern, the experienced operator that had been recommended by Mr. Pocius, to create a budget of the estimated expenses for the administration, management and operations of the Center. Northwestern submitted a budget (based on their own operation of a youth academy). PACC's principals cut a substantial amount of waste from that budget, and then, using an 80% occupancy rate, calculated its per diems. PACC's initial 80% occupancy rate is consistent that used by other facilities and PACC

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cited by way of relevant example the 80.6% occupancy utilized by another provider of these services, Northwestern, in calculating its per diem, as accepted in a parallel BFO Audit Report issued with respect to one of Northwestern's detention facilities. *See* Exhibit "E" Audit Report of Northwestern Academy Detention Program. PACC also reviewed per diem rates from comparable facilities throughout Pennsylvania and actual county per diem expenditures. Total projected operations costs were then divided by the number of available beds on a per diem.

In negotiating the original 2003 provider contract, PACC and Luzerne County reviewed actual juvenile detention payments in other counties for 2000, 2001 and 2002. PACC believes and asserts that the rates as negotiated were reasonable and not excessive and did not result in excessive profits to the provider.²

Although denied by Mr. Pocius, PACC principal Robert Powell asserts that he discussed with Mr. Pocius PACC's projected per diem rate at the time of the initial inspection as would be natural given Mr. Pocius position as Regional Director of OCYF. According to Mr. Powell, Mr. Pocius told Mr. Powell that he had no problem with the per diem. Additionally, PACC's per diems were disclosed to the Department as part of Luzerne County's budget for child welfare services for 2003.

PACC began accepting placements in February 2003 for detention, and then in March 2003 for treatment. Thereafter, and for the eleven months of operations in 2003, PACC's auditors prepared an internal financial statement that reflected the operational costs for the facility which did not include any actual and documented administrative, managerial and tax expenses incurred by the principals of PACC. The internal financial statement purported to reflect a "net income" to PACC of \$1,201,057. A copy of this financial statement was provided to the Department on August 9, 2004, without a full appreciation by BFO of its limited

²A critical conclusion of the Audit Report was that, under applicable Federal Regulations, PACC was required to use a "cost analysis" as opposed to a "price analysis" because "adequate price competition is lacking." Audit Report at 5. The Audit Report asserts: "Since the PACC facility is the sole detention facility in Luzerne County, adequate price competition is lacking. As a result the County should have performed a cost analysis of the PACC per diems." *Id.* This conclusion ignores the nature of the facility and the relevant market. By defining the relevant market as Luzerne County, the Audit Report overlooks relevant evidence and circumstances whereby Luzerne County had previously utilized facilities throughout the region, state and even in other states. The relevant market and benchmarks for calculating the proper payments for Luzerne County's detention and treatment services includes a myriad number of facilities and not just those within the geographical confines of the County. *See* Exhibit "F" Fee for Service Schedule for Luzerne County for 2003-2004 showing higher per diems paid for detention to Schaffner Youth Center (\$274.58/day) and treatment (Y.D.C. Loysville \$310.00/day; Y.D.C. New Castle Secure \$330.00/day; Allentown Secure \$330.00/day).

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examination and scope. PACC provided detention services at the facility through December 31, 2004.

In November 2004, PACC negotiated with and leased the PACC facility to Luzerne County. The lease is a twenty (20) year lease effective January 1, 2005, including rental payments of \$193,333 per month.

C. The Department's audit of PACC

In October 2004, the BFO announced that it would conduct an audit of PACC. Prior to the audit and based upon discovery in the Luzerne County proceedings, PACC learned that BFO Audit Director Thomas Crofcheck had communicated to various Department officials his conclusions, formed prior to the institution of the audit, that PACC had "earned a \$1.2 million profit on the sale of \$4 million in services. This is a 30% profit. In the same year PA Child Care gave members of the LLC distributions (dividends) of \$2 million." In a second E-mail, Crofcheck communicated the false statement that: "This facility has the highest per diem in the state." See Exhibit "G," E-mails from Thomas Crofcheck to Marilyn Eckley dated October 19, 2004 and October 21, 2004. Despite having already reached these unsubstantiated and incorrect conclusions prior to the audit, Mr. Crofcheck executed an Independence Statement as to the conduct of the audit. See Exhibit "H."

The intention to audit was communicated to PACC by letter dated October 26, 2004. The letter, as well as the Department's policies and practices, set forth the standard parameters of the audit, including the requirement of confidentiality during the audit process. See Exhibit "I", Letter of October 26, 2004. The October 26, 2004 BFO letter, which initiated the audit process, stated that the audit was being conducted pursuant to the provisions of 55 Pa. Code § 3170.106(a) and would begin with an Entrance Conference on November 3, 2004 at the PACC facility under review in Pittston, PA. The process for the conduct of the audit was then outlined as follows:

- the scope and objective of the review was to be discussed at the November 3, 2004 Entrance Conference;
- the review would be completed by December 1, 2004;
- onsite fieldwork by BFO auditors would commence immediately following the Entrance Conference and working space at the facility was requested for that purpose;
- a Closing Conference would occur with representatives of PACC at the conclusion of the onsite field work;

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- a confidential non-public draft audit report would be provided for review by representatives of PACC with an opportunity for a written response prior to any public distribution of the report;
- an Exit Conference could be requested and would be scheduled within forty (40) calendar days of receipt of the draft report by PACC;
- a written response would be requested and incorporated into any final report and such response would be provided in advance of any Exit Conference by a period of ten (10) days;
- the final public report, when distributed, would include consideration of the written responses and discussion at both the Closing and Exit Conferences.

During the course of the audit, PACC clearly and indisputably informed the BFO auditors that there was additional financial information reflecting costs and expenses not included in the 2003 financial statement referenced above. PACC requested its auditors and financial advisors to prepare additional information. On November 9, 2004, PACC's Chief Financial Officer Patrick Owens informed the BFO auditors that some requested information could not be disclosed because of its proprietary nature and its disclosure could jeopardize PACC's competitive market position. *See* Exhibit "J" BFO Meeting Summary. On that same day, PACC's principals met with the BFO auditors and reiterated Mr. Owens' concerns. Mr. Powell and Mr. Zappala, however, expressed their desire to cooperate and suggested a conference call with BFO supervisors "...to see if there is a way to accommodate BFO's needs without giving the competition access to proprietary information." *Id.*

Apparently, the BFO auditors gave no credence to PACC's efforts to devise a procedure whereby PACC's proprietary information could be communicated to the Department. To the contrary, two strategies coalesced to coerce PACC's disclosure. First, at the request of Mr. Crofcheck, on November 15, 2004, Mr. Pocius and the Regional Office of Children, Family & Youth sent a Licensing/Approval Inspection Summary indicating a failure in the context of the audit to supply unspecified information to BFO and commenced a license enforcement proceeding against PACC's license based on its alleged refusal to provide that information. *See* Exhibit "D" at 69-70. *See also* Exhibit "K" Letter of November 15, 2004 from Leonard J. Pocius to PACC commencing license enforcement proceeding. Mr. Crofcheck never advised Mr. Pocius that PACC had discussed providing information on a confidential basis to BFO and had requested a conference call to suggest a means to do so. *See* Exhibit "D" at 73. Prior to sending out the Licensing/Approval Inspection Summary requiring a response from PACC with ten (10) days, Mr. Pocius made no attempt to contact PACC. *See* Exhibit "D" at 83-84. PACC counsel did contact Mr. Pocius on November 22, 2004. Significantly, before PACC ever

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received a copy of the Licensing/Approval Inspection Summary, Mr. Crofcheck sent a copy of it to Luzerne County officials. See Exhibit "D" at 96-97. Mr. Pocius conceded that this disclosure was unfair. *Id.*

In addition, the Controller of Luzerne County, Stephen Flood, issued a subpoena to the Department for all records relating to the PACC audit. On November 19, 2004, Flood issued an subpoena directly to Mr. Crofcheck demanding the production of "[a]ll records and audits, including the most recent audit, pertaining to PACCare [sic], LLC, Juvenile Detention Center, Pittston Twp., Pennsylvania c/o Robert J. Powell Esq." The subpoena further demanded production of the documents on November 23, 2004 -- just two business days after the subpoena was issued. As Mr. Crofcheck was supervising the Department audit of PACC's juvenile detention facility and pursuant to that audit, he had been given access to PACC's internal financial documents collected during the audit prior to that date. Similar subpoenas were issued to PACC and to various Luzerne County officials, all of whom challenged the blatantly illegal subpoenas by filing motions to quash in the Court of Common Pleas of Luzerne County. Mr. Crofcheck however rapidly complied with the subpoena and produced the documents on that date as chronicled in an article appearing in the November 24, 2004 edition of The Times Leader in Wilkes Barre. That article stated:

County Controller Steve Flood and his staff spent much of Tuesday reviewing more than 500 papers provided by the Department of Public Welfare in response to his subpoena issued last week.

Flood said he and his staff will work through the Thanksgiving holiday so they can prepare an audit highlighting their findings, hopefully for release next week.

D. The Luzerne County litigation

In December 2004, PACC brought an action in the Court of Common Pleas of Luzerne County seeking relief under the Uniform Trade Secrets Act, 12 Pa.C.S. § 5301 *et seq.*, and requesting, *inter alia*, special, preliminary and permanent injunctive relief, as well as compensatory and exemplary damages, attorneys fees, costs and other relief deemed appropriate by the Court. The action expressly pleaded the wrongful misappropriation of the trade secrets of PACC by Mr. Flood, Mr. Crofcheck and Mr. Pocius. As expressly pleaded in the Complaint, PACC asserted that Mr. Flood, as the Controller of Luzerne County, and Mr. Crofcheck and Mr. Pocius, though employees of the Department of Public Welfare, *in their individual capacities*, and acting individually and in concert, obtained and publicly disseminated PACC's internal, confidential and proprietary trade secret information. Prior to the commencement of litigation, Mr. Flood, through use of his subpoena power which PACC asserts was blatantly improper, and

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with the apparent cooperation of Mr. Crofcheck, had obtained documents which contained confidential and proprietary trade secrets of PACC and broadcast his intent to disclose this information publicly. Moreover, after receiving notice of the pendency of the court action as well as the subsequent issuance of the injunctive order prohibiting disclosure of PACC's trade secrets, Mr. Flood turned over the documents and information illegally subpoenaed from Crofcheck to *The Times Leader*. After the improper release of the information, PACC refused to provide additional information to the Department.

PACC sought and obtained a Special Temporary Injunction prohibiting those defendants "from taking any action, directly or indirectly, to acquire, maintain, communicate or disclose any trade secret of PACC pending further Order of this Court." On December 23, 2004, the parties agreed to continue the Special Injunction in full force and effect. That injunction remains in effect.

Mr. Flood's dissemination of PACC's internal and confidential documents in violation of the Special Injunction is the subject of a contempt proceeding in the Luzerne County Court.

In the Luzerne County proceedings on December 23, 2004, Mr. Flood produced, pursuant to subpoenas issued by counsel for PACC, copies of the documents containing PACC's proprietary information that he obtained from Mr. Crofcheck. These documents, or a significant portion of these documents, had been willfully disclosed by Mr. Flood to reporters from *The Times Leader*, and contain not only the confidential and proprietary "trade secret" information of PACC, but also contain internal records of PACC containing census information on the juveniles admitted to the facility, including the names of, and other identifying information about those juveniles, and whether the juveniles were in detention or in treatment. Thus, there is a substantial basis to assert that Mr. Crofcheck and Mr. Flood permitted the disclosure of not only the trade secrets of PACC, but also confidential information about juvenile detainees and delinquents as to which the juveniles have significant privacy interests and confidentiality rights under the Juvenile Act.

Despite the prohibition on further disclosure, Messrs. Crofcheck and Pocius and their counsel, in the context of an appeal from a challenge to the jurisdiction of the Luzerne County court, publicly filed with the Supreme Court of Pennsylvania an appendix which included the referenced confidential materials belonging to PACC and the names and status of juveniles in detention and/or treatment.

It is of notable significance to PACC's position, as to the content and findings in the Audit Report and the appropriateness of the contract negotiation process and payments under the contract, that, during the course of discovery in the Luzerne County litigation, Mr. Crofcheck

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testified under oath that he agreed PACC was entitled to reasonable profits and to deduct administrative expenses in the calculation of net income, to wit:

Q. Apart from the operation of the center, would you agree that there are legitimate costs involved in the management of the company operating the center that are attributable to—or reasonable in considering the per diem?

A. Yes, there are.

Q. What kind of costs would those include?

A. They would be—you're talking about management costs, correct?

Q. Management costs.

A. All right. Chief financial officer's salary, clerical costs. There—there could be an amortization of space, like, from this office (The Powell Law Group, PC), okay, utilities, whatever's—costs associated with this office, a percentage could be associated, if this is the office of Pa Child Care. There—there could be initial costs of the audit—certified audit, financial advise, legal advice There are many expenses that would be considered as legitimate expenses of running an operation like Pa Child Care.

Q. How about the—some compensation for Mr. Powell and Mr. Zappala for their efforts in creating, implementing, and overseeing the operation of Pa Child Care?

A. That would be an eligible expense or an expense considered appropriate for PA Child Care.

Deposition of Thomas P. Crofcheck, Page 43, line 21– Page 44, Line 22. A copy of this testimony is appended hereto as Exhibit "L."

E. The circumstances surrounding the issuance of the Audit Report

In March 2005, the Department issued an initial "draft" Audit Report regarding the audit of PACC (which version is the predecessor to the February 6, 2007 "draft" Audit Report). The March 2005 "draft" Audit Report did not emanate directly from BFO for the Department to PACC which is standard practice. To the contrary, it was transmitted to counsel for PACC through counsel for Messrs. Crofcheck and Pocius in the Luzerne County litigation. In May 2004, PACC's counsel sent a comprehensive response *inter alia* objecting to the procedural irregularities in the issuance of that draft report and detailing the erroneous conclusions,

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regulatory and statutory misinterpretations and the blatant prejudicial nature of that report in terms of PACC's compliance with applicable law and its reputation in the provider community.

Thereafter, in seeking to supplement and correct the unfair, incomplete and faulty information, analysis and conclusions contained in the March 2005 version of the Audit Report, and having obtained the critical concession by Mr. Crofcheck as to PACC's right to have its management and administrative costs considered, PACC once again attempted to explore a mutually acceptable and protected means to provide additional material information to the Department. PACC expressed its desire to have the information maintained by the Department confidentially in light of the repeated public disclosures of PACC's internal information that had already occurred by Mr. Flood's improper subpoena, in the Luzerne County newspapers, and in unsealed pleadings filed with the Supreme Court of Pennsylvania that were obtained and reported again by the Luzerne County newspapers. Despite repeated meetings among PACC and Department's counsel at which various proposals were exchanged, no agreement could be reached. PACC continued its efforts at resolution until the issuance of the revised Audit Report by the Department on February 6, 2007.

SUMMARY OF RESPONSES TO AUDIT FINDINGS

Luzerne County fairly and effectively negotiated with PACC in 2003 a reasonable set of per diem rates for secure juvenile treatment and detention services considering its need for such services and based upon comparable rates in other counties

PACC as a new enterprise calculated its offered per diem rates on cost projections and reasonable occupancy projections and earned reasonable returns based upon its overall risk assumption, largely based on nearly 100% occupancy, not 80% as projected

The January 2005 capital lease is not a capital lease, as the Audit Report grossly understates the value of the underlying assets

PACC billed Luzerne County for all days on which any individuals was in detention including the day of admission and the day of discharge consistent with the terms of its prior contracts and not contrary to any stated or unstated policy or regulation of the Department of Luzerne County

PACC and Luzerne County entered into a provider agreement which is consistent with Departmental regulations as to the terms of such provider contracts

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RESPONSE AND ANALYSIS

1. **The County did not fail to negotiate the per diem rates for services and the utilization of a price analysis, in conjunction with a cost analysis, was proper.**

Luzerne County has the responsibility to arrange and provide for certain child welfare services under the provisions of the County Code at 16 P.S. § 101 et seq., with specific reference to those responsibilities at Section 2168. Further, Luzerne County is required to procure such services pursuant to the contracting process set forth in the Department's regulations for child welfare services at 55 Pa. Code § 3170.1 et seq. Section 3170.94 sets forth that each county shall follow the procurement and bidding standards prescribed by the appropriate county code. Luzerne County chose to procure child welfare services by negotiation with PACC and conducted those negotiations in conformity with 55 Pa. Code § 3170.85, which mandates that "...the appropriate county authorities are responsible for obtaining the best possible rate for purchase of services by the county children and youth agency."

The Department reimburses counties in terms of maximum amounts as set forth at 55 Pa Code § 3170.84. One of the benchmarks of such maximum rates and reimbursement is the rate "...charged another government agency which purchases the same services from the provider agency." Luzerne County and PACC referenced rates charged by other counties for similar services and indeed relied upon Department calculations and reports in reviewing a range of rates. See Exhibit "E." It is particularly significant that PACC charges less than competing facilities operated by the Department. See Exhibit "M" BFO worksheet on comparison per diems showing facilities charging higher per diems than PACC.

Although the regulations require counties to negotiate, the negotiations, as any negotiations are governed by the practical laws of supply and demand. Luzerne County was in need of immediate access to secure juvenile detention and treatment services and looked to other counties for fair and reasonable rates in the absence of alternative vendors for such services. In fact, an audit survey undertaken by BFO for the Department when it audited Northwestern, another provider of these services in other locations in Pennsylvania, supports this reference to rates in other counties. See Exhibit "E." In the Northwestern audit, BFO contacted juvenile probation offices in Monroe, Schuylkill, Lebanon, Northumberland and Perry Counties to understand and benchmark the rate development process. In response to the question to these counties - "Do you negotiate rates with the detention centers or request line item budgets so you are aware of the costs that are included in the line item rate?" - , the counties' response was "The counties do not negotiate rates and generally feel powerless regarding such negotiations." Rates are based upon what a willing vendor believes to be reasonable and what other counties are paying.

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PACC reasonably projected its own expected costs of services as a new facility and the calculated risk in assuming the responsibility for juvenile detention services which had previously been provided directly by Luzerne County. PACC and Luzerne County reviewed actual juvenile detention payments in twenty-five (25) counties for 2000, 2001 and 2002 and reasonably increased those rates for inflation by 4% annually. The calculated per diem rates for the three (3) counties which paid the highest rates were Montgomery, Bucks and Philadelphia Counties which exceeded \$303 for 2003 and \$315 for 2004. The rates negotiated between Luzerne County and PA Child Care for 2003 as set forth in the agreement for that year were \$268 per day for juvenile detention services and \$300 per day for secure treatment services. For 2004, those rates were increased to \$290 per day for juvenile detention services and \$322 per day for secure treatment services. These rates are consistent with "market" rates and the methodology established for appropriate and maximum levels of Departmental reimbursement at 55 Pa. Code § 3170.84. The rates as negotiated were reasonable and not excessive and did not result in excessive profits to the provider.

Despite the lack of alternative vendors upon whom to exercise bargaining power, Luzerne County did effectively negotiate and agreed upon the rates lower than those charged in other similar large counties, including Bucks, Philadelphia and Montgomery, and indeed, far less than the rates charged by the Department for placement in one of their Youth Development Camps. Essentially, the rates negotiated by PACC with Luzerne County are within the range of rates charged to other similar counties and by the Department at one or more of its own detention facilities.

2. PACC did not make an excessive profit and its per diem rates were appropriately calculated.

Even before the audit had commenced as documented by the Department's internal memoranda and email cited above and disclosed in the related litigation in Luzerne County, BFO personnel had apparently made an early and undocumented determination that PACC had made a profit of \$1.2 million and had additionally distributed dividends of \$2 million to members. BFO personnel also erroneously concluded that PACC charges the highest per diem in the state. These premature conclusions are completely without factual support and offend the concept of fairness and evenhandedness inherent in the audit process. The \$1.2 million "net income" appeared on a preliminary copy of the financial statement for PACC as to 2003 is appended hereto as Exhibit "N" and does provide a full accounting of PACC's true revenue for that year.

PACC as an LLC is owned by two (2) separate corporate entities in equal shares. The "net income" of \$1.2 million dollars referenced is not, according to any reasonable economic or tax analysis, the final "profit" of the entity. BFO did not have full information as to all of the

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detailed operating costs of PACC, including debt service, administrative costs, insurance costs, taxes, maintenance costs, initial development costs, construction management costs, capitalized interest and other risk related costs incurred for the start-up of this new facility in early 2003. To calculate the actual profit or loss to the corporate owners of PACC, all operational expenditures incurred in the management, supervision, financing and operation incurred by each corporate owner must be subtracted from their share of gross profit. The result of this calculation is the before tax profit or loss of each entity.

Both at the time of the audit, in November 2004, and more recently, PACC asked for an opportunity to share with the Department the relevant information regarding operational expenditures incurred in the management, supervision, financing and operation, which would demonstrate the inaccuracy of the Department's conclusions regarding alleged profit. These responsive efforts were derailed by the Department's licensure enforcement actions in November, 2004, and by the improper disclosures to the press by individuals employed by the Department of sensitive internal financial information regarding PACC. PACC has provided to its counsel an independent auditor's report as a supplement to prior audits for 2003 denominated "Supplemental Information" which sets forth additional relevant information regarding operational expenditures incurred in the management, supervision, financing and operation, and shows general and administrative expenses for that year reducing the net income of PACC by approximately \$1 million. A copy of that supplemental report with "Supplementary Information" for 2003 is attached hereto in a sealed confidential envelope as Exhibit "O."

The Department's assertions regarding profit are also contrary to the testimony of their own auditor, Mr. Crofcheck, who acknowledged that the type of expenses reflected in the Supplementary Information are allowable and proper in calculating actual income. See Testimony of Crofcheck quoted herein *supra*.

Moreover, the referenced BFO audit of Northwestern supports the handling of initial gross one year profits of approximately \$1.2 Million Dollars for Northwestern's operation of a similar, yet smaller, juvenile detention center before deducting certain expenses. The BFO auditors subtracted significant administrative expenses from that initial "profit" so as to calculate net profit based on the verbal representations of the Chief Financial Officer of the audited entity. The result was then an acceptable and accurate audit in the Department's opinion. The report was supplied to Mr. Crofcheck who was aware of that result. A copy of the BFO audit of Northwestern is appended hereto as Exhibit "E."

In terms of total revenues from Luzerne County in a given year, the actual number of service days billed to Luzerne County by PACC were established by the actual high need for services, a factor not in any way controllable or influenced by PACC. At the time of negotiation with Luzerne County, PACC could not predict what the occupancy of the facility would be and included some revenue protection with respect to the circumstance whereby the facility would

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not be full, using an 80% occupancy figure. The negotiations were arms length and fair and based upon reasonable rates derived from the actual costs and risks assumed by PACC and per diem rates paid for other comparable services in other Pennsylvania counties.

The conclusion advanced in the Audit Report as to a possible disallowance in terms of federal TANF claims and any possible repayment of funds is therefore based on unfounded speculation. Instead PACC asserts that the per diem rates were fairly negotiated but demand for the services was higher than anticipated -- the facility was full. The circumstance that Luzerne County exceeded its Departmental allocation for child welfare services in FY 2003-2004 by \$2,772,801 was not based upon any failure of the rate negotiation process, but rather on that high service demand in Luzerne County driven by placements from the juvenile courts under the provisions of the Juvenile Act as set forth at 42 Pa. C.S.A. § 6301 et seq. PACC agrees that it is the responsibility of Luzerne County to be a prudent buyer and to monitor all contracts for appropriate compliance with applicable regulations and appropriate reimbursement from the Department and other funding sources. There is no question that Luzerne County exceeded its Departmental allocation for these programs but such costs are attributable to the demand for services and not to inappropriate rates charged by PACC.

3. The Audit Report's treatment of the capital lease issue is based on speculation

The Audit Report asserts that the payments under the January 2005 twenty year lease, which was a speculative and prospective conclusion by BFO in November 2004, at the time of the audit survey, drive a further conclusion that the lease payments amount to the transfer of substantially all of the benefits and risks inherent in the ownership of the property to the lessee so as to characterize the lease as a "capital lease." Further, the Audit Report asserts that the Department under the provisions of 55 PA Code Section 3170.11 requires "prudent buyer" principles to apply and limits reimbursement under Section 3170.52 by requiring allowances only for the lesser of fair market value or actual costs regardless of the nature of the lease as capital or otherwise. BFO admits that it could not calculate actual costs of depreciation and interest for 2003 or 2004 so as to apply those costs as adjusted for 2005 and going forward under the lease. The record does not contain evidence of those costs or of fair market or rental value in any sense.

PACC asserts that a just determination of present market value includes not only the initial property acquisition but all of the development costs, construction management fees, taxes, insurance, capitalized interest, and other expenses related to the establishment of the facility. PACC asserts that the lease is not a capital lease as the present value of the facility even at the start of the lease in 2005 is significantly higher than the total then-present value of the

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cumulative lease payments by Luzerne County for twenty years. As to the more significant question as to the fairness and reasonableness of the lease payments, PACC asserts that such payments are consistent with "prudent buyer" principles and with the relevant market place for such facilities, recognizing that the Pittston facility is a unique "state of the art" juvenile detention facility. PACC is however not only ready and able to demonstrate the reasonableness of the lease payments in terms of the valuation of the underlying leased asset and to work with the Department and with Luzerne County to demonstrate appropriate market value on which the lease negotiations were based to support the conclusion that this lease is fair and prudent, PACC is also willing to examine with the Department alternative methods for fair market valuation which take into account the actual costs to develop and the operating value of the facility at the time of the lease in 2005 and going forward to support fair lease payments to the mutual satisfaction of the parties and to satisfy the provisions of 55 PA Code Section 3170.52.

4. **PACC did not improperly invoice for both the day of admission and the day of discharge and therefore overcharge Luzerne County by \$400,590.**

The Audit Report concludes that PACC should not have been paid a per diem rate for the day of discharge of a youth or adolescent at the facility or when a juvenile was transferred within the facility from juvenile detention to secure treatment. BFO cites no regulation to support its conclusion that it is "general industry practice to make payment for the day of admission but not [for] the day of discharge." To the contrary, it has been the confirmed practice of Luzerne County as evidenced by discussions with Paul McGarry as Director of Probation Services for the county, and in the Department's own workpapers, that there is no policy or requirement with respect to not paying for services on the discharge date. Such conclusion is further confirmed by email correspondence and other documentation from within BFO as to the absence of any such regulation or Departmental policy directive. Therefore, absent a specific contractual provision or other regulatory limitation, Luzerne County continued its past practice of allowing payments for such days. The BFO recommendation that Luzerne County revise such language in future contracts may be considered and Luzerne County may in its discretion make such modifications.

PACC's contracts with Luzerne County and other counties explicitly permit PACC to charge for day of admission and every day thereafter. The documents produced by the Department demonstrate efforts to find some basis to disallow payment for the documented day of discharge despite the clear terms of the contracts and the absence of a prohibition on such practices in any cited regulation. See Exhibit "P." Ultimately the Department relies on the language at 55 PA Code §§ 3170.11(b) and 3170.85 to the general effect the Department will participate only in the payment of those expenditures which are necessary and justifiable for program operations and that are in the same nature as expenditures which would be made by a prudent buyer in the marketplace.

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Review of the documentation provided by Mr. Crofcheck in the Luzerne County litigation shows that tremendous effort was exerted to find some authority that prohibited PACC billing for the first day and every day thereafter. None was ever found. Indeed, PACC's own research discloses no authority that prohibits billing in this manner.

Significantly, the documentation provided by Mr. Crofcheck in the Luzerne County litigation discloses that Mr. McGarry as Luzerne County's Director of Probation has disclosed directly to BFO, in the strongest terms possible that, not only has Luzerne County routinely paid other facilities, including those in Lackawanna County, for the date of discharge, but Luzerne County itself has billed other counties who sent their juveniles to Luzerne County for date of discharge and received payment. *See* Exhibit "Q." Clearly, PACC's practice is not improper or unusual as it comports with Luzerne County's own practice both as a provider and user of juvenile detention and treatment services. Luzerne County was following its own prior contracting practices and included explicit language in the PACC contract as a prudent and consistent buyer of services.

5. Response to Issue No. 5: Luzerne County used a non-standard placement agreement to contract with PA Child Care.

PACC is unaware of any "standard purchase of service agreement" for the purchase of child welfare services by Luzerne County or by other counties. The requirements for any provider contract are set forth at 55 Pa. Code § 3170.93. At subsection (e) is an enumerated list of the terms which must be included in such agreements, to wit: (1) the signature of the chairperson of the county commissioners, or a duly authorized representative, and an authorized person for the service provider; (2) the names and addresses of the contracting parties; (3) the effective date and term of the contract; (4) the contracted amount or unit price and payment schedule; (5) provisions for contract modification amendments or terminations; (6) prohibitions against reassignment without county permission; (7) a work statement; (8) required reports for the county and the Department; (9) maintenance and retention of required records, documents, and accounting books; (10) audit rights for the county and the Department; (11) procurement of liability insurance; (12) client-confidentiality and right of privacy provisions; (13) units of service to be provided and their definitions; and (14) provisions as to non-discrimination. In each of the PACC contracts for 2003 and 2004 which are essentially identical, these provisions are contained in the contract as follows:

1. Full signatures on the signature page
2. Names and addresses of the parties in the initial paragraph

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3. Effective dates and term of the contract in the initial paragraph and at Section V
4. Payment provisions at Section X
5. Provision for modification at Section XVII
6. Prohibition against reassignment at Section XVI
7. Work statement at Sections I, II, III, VI, VII, VIII and IX
8. Required reports at Section XI
9. Audit rights at Section XII, specifically referencing the fact the PACC shall comply with all federal and state audit requirements
10. Liability insurance at Section XII
11. Client confidentiality and rights of privacy at Section I(a) relating generally to the laws and regulations governing the delivery and funding of child welfare services in Pennsylvania
12. Units of service are defined at Section X
13. Non-discrimination provisions at Section XII.

The contracts as written are in full conformity with the regulatory provisions for such contracts cited above.

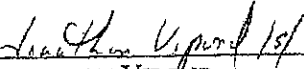
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In sum, PACC negotiated fairly with Luzerne County, established rates based upon recognized county benchmarks, complied with applicable regulations as to the substance of such negotiations and the contract terms and supplied services to the satisfaction of the county. PACC stands ready to yet devise mutually agreeable and protected methods of supplying additional financial information to support its assertions and with Luzerne County and the Department to examine the ongoing lease. We look forward to meeting with you promptly to address these concerns and to avoid the release of the Audit Report in this unacceptable form.

Sincerely,

BUCHANAN INGERSOLL & ROONEY, PC

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October 26, 2007

VIA TELEFACSIMILE AND FIRST CLASS MAIL

Allen Warshaw, Esquire
 Chief Counsel
 Pennsylvania Department of
 Public Welfare
 Health & Welfare Building, 3rd Floor West
 Harrisburg, PA 17120

RE: Draft Audit of PA Childcare, LLC

Dear Mr. Warshaw:

At the conclusion of our meeting on Tuesday, October 23, 2007, you requested that I provide you with a proposed schedule of action items demonstrating efforts to advance the resolution of outstanding issues in order to bring this audit process to a prompt conclusion. Since then I have had the opportunity to discuss the matter further with PACC's CFO, Patrick Owens, as well as PACC's principals. Additionally, PACC has consulted further with its accountants. Based on those discussions, I would propose the following:

I. Additional Support for PACC Administrative Expenses

For the first time at our meeting on October 23, 2007 you requested an opinion from PACC's accountants verifying the validity of our Administrative Expenses. We are prepared to produce for inspection information in that regard at a meeting with you and Messrs. Friel and Dallas.

Our request for a meeting and/or extension is certainly reasonable in light of the history of this matter, and in particular, since PACC only learned of the heightened standards and scrutiny being applied to PACC which was again evident at our meeting of October 23, 2007.

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Allen Warshaw, Esquire
Chief Counsel
October 26, 2007

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I will not recount the problems that arose with the previous Audit Team as those facts are set forth in PACC's March 8, 2007 letter to BethAnn Smetak (Section C, at pages 7-9). As is evident from that discussion, PACC was prepared to document its internal expenses in November, 2004. Instead, PACC's private and confidential proprietary information was leaked to the press with the assistance of Department employees, and the principals of PACC were not given the same opportunity as their competitors, i.e. Northwestern Human Services, to support claimed administrative expenses, as more particularly described later herein.

In the above-referenced letter, as a demonstration of its good faith and in an effort to resolve the issue regarding PACC's calculation of its *per diem*, PACC submitted a confidential supplementary report from its auditors regarding PACC's administrative expenses. The Department, after a period exceeding six months, issued its Revised Draft Audit on September 25, 2007. Without any explanation whatsoever, the Department rejected all administrative expenses of PACC.

It was not until our meeting of October 19, 2007 that Messrs. Friel and Dallas informed PACC that the Department required additional documentation of the expenses set forth in the confidential supplementary report. We requested that Messrs. Dallas and/or Friel provide specifics as to the requisite supporting information. Their response was that the schedules of allocated expenses and documentation regarding Messr. Powell and Zappala's rates and hours would suffice to finally put this issue to rest.

Once again, in the spirit of cooperation, PACC immediately scheduled a follow up meeting to produce PACC's administrative expense detail as requested. When we met on October 23, 2007, Mr. Vipond and I were accompanied by Mr. Owens who produced and explained in detail schedules showing precisely how PACC's administrative expenses were calculated. Further, those expenses were tied to ledger entries, financial statements and tax returns. The Department's response was shocking in that the bar was raised again and, for the first time, we were informed that the only documentation acceptable to the Department was a certification from PACC's auditors as to the administrative expenses.

We question why the Department, having received the supplementary report from PACC's auditors in March 2007, did not contact PACC and request additional information for over seven months if it believed the supplementary report was insufficient. We also reasonably question why the Department continues in its disparate treatment of PACC - i.e., accepting the undocumented verbal representations of Northwestern's CFO, while rejecting a written report of PACC's auditors and the supplemental documentation provided by PACC's CFO. Any audit is supposed to be done using the same rules, yet the Department continues to ignore this fact. This disparate treatment has not been lost on my client.

Notwithstanding these issues, PACC believes it can produce for inspection documentation that should be more than acceptable under any reasonable requirement of the Department as to the

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Allen Warshaw, Esquire
 Chief Counsel
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bona fides of its administrative expenses. PACC will within the next two weeks obtain additional documentation from its accountants. In light of all of the above, PACC requests a meeting at the Department's earliest convenience, to produce the same for inspection. This request is certainly reasonable in light of all the circumstances.

2. Discussions regarding Renegotiation of the Lease with Luzerne County

The County has represented to PACC and the Department that it is extremely happy with the lease. In fact, at our meeting of October 23, 2007, County Manager Sam Guesto informed the Department that the lease has resulted in substantial savings to the County and the Commonwealth for juvenile detention. Simply stated, the lease has done exactly what the County anticipated it would – it has been a win-win for the County and the State taxpayers. The following is a recap of those savings:

	County Funds	State Reimbursements
2004	\$15,600,000	\$5,600,000
2005	12,700,000	
2006	11,100,000	
2007	9,430,000 (projected)	3,970,000 (projected)

Luzerne County now charges a \$302 per diem for detention at its facility which is a mere 15 minutes from the Courthouse where these juveniles appear in Court. As shown by the chart attached as Exhibit "A," which incorporates the latest rates from institutions responding to a survey conducted by J.D.C.A.P., factoring in transportation and personnel costs, the per diem cost to send Luzerne County juveniles to the other institutions ranges from \$326.46 per juvenile per day to \$501.13 per juvenile per day. Simply stated, the best use of taxpayer dollars has been and is the PACC facility.

As stated, PACC is more than willing to open discussions with Luzerne County regarding the lease for the juvenile detention facility to address the capital lease issue.

Two alternatives present themselves: (1) an amendment of the lease *ab initio* to adjust the term of the lease to a term that renders the lease an operational lease rather than a capital lease, and (2) discussions regarding the terms for terminating the lease.

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A. REDUCTION OF LEASE TERM

Accepting for the purposes of argument that the lease is a capital lease, a conclusion which PACC steadfastly disputes, it must be recognized that when the parties entered into the agreement, neither considered whether the lease was a capital lease or an operational lease. The County wanted to have a long term solution to containing its costs for juvenile detention and treatment and PACC was willing to accommodate that interest. PACC is perfectly willing to discuss adjusting the term of the lease and has been advised that a term adjustment should most certainly put to rest the disputed claim that the lease is a capital lease.

B. LEASE TERMINATION

It is odd, to say the least, that the Department would want to interfere with a lease that has resulted in significant cost savings to the taxpayers of the Commonwealth and Luzerne County. If the Department wishes to shoulder that responsibility and explain to those same taxpayers why their tax burden will now increase, that is your decision. We are committed to publicly communicating this to the County and the taxpayers if this is the Department's preferred method for resolution.

Assuming arguendo that PACC would agree to terminate the Lease, which would require a mutual termination from the County, which neither party has agreed to, minimally, PACC would require an authorized representative of the Commonwealth to execute a Hold Harmless Agreement to release PACC of any liability from the County and/or taxpayer(s).

C. CONCLUSION

While PACC is willing to discuss either of these alternatives, we are not are willing to re-negotiate per diem rates that we are know are justified. PACC is confident that after reviewing the additional documentation regarding PACC's administrative expenses, the Department will agree that they are fair and reasonable.

PACC would propose that any discussions regarding the lease also take place at the aforementioned meeting.

3. Outstanding Issues

PACC would also like to meet and discuss further the "market analysis" performed by Mr. Friel in the Revised Draft Audit Report. In particular, Mr. Friel performed a putative analysis of the difference in per diem rates for detention in which he concludes PACC charged an unreasonably high rate. The problem with this analysis is he did not perform a similar analysis for treatment (a/k/a long term residential). Had Mr. Friel performed such an analysis, he would have found only an \$18 difference between PACC's per diem and the average per diem of other providers providing juvenile treatment services to Luzerne County, a difference that is easily justified in light of the fact that

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Allen Warshaw, Esquire
Chief Counsel
October 26, 2007
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PACC and its principals must pay federal and state income tax on income earned.

Lastly, PACC would like to discuss with Mr. Friel the source of his information on the detention rates charged by surrounding counties as found in the chart on page 7 of his Revised Draft Audit. It has been our experience that Auditors disclose the sources for their information. Additionally, we would like to know whether the Department he performed a comparative analysis of the per diem rates paid for treatment in the counties offered as a comparison.

In closing, PACC believes that the time schedule proposed to continue discussions is fair and reasonable and we hope to meet with you at your earliest convenience.

In the event that the department is unwilling to meet, PACC will require additional time to prepare its response to the Revised Draft Audit Report. We would request an additional week from the October 27, 2007 deadline stated by Mr. Dallas, so that our written response would be due Monday, November 5, 2007.

Jonathan Vipond, counsel for PACC, joins in this request.

Thank you for your consideration.

Sincerely,



GEOFFREY R. JOHNSON

GRJ/mw
Encl.

cc: Jonathan Vipond, Esquire
Robert J. Powell, Esquire
Gregory R. Zappala, Esquire

County	Per Diem	Costs (\$2017)	Transportation Costs (.493 per mile)	Other Costs	Day 1 Total Cost	Day 2-5 Per Diem Cost	Day 6 Total Cost	Average Per Diem Cost	Annual Per Bed Cost	Annual Cost 24 Bed	L.C.J.C. Annual Cost 302	Additional Cost to Limestone Ck.
Bucks	408.85	200.00	46.84	30	685.69	1,635.40	685.69	501.13	182,912	4,389,898	2,645,520	1,744,368
Dauphin	328.66	200.00	51.40	30	610.06	1,314.80	610.06	422.46	154,198	3,700,750	2,645,520	1,055,230
Montgomery	278.70	200.00	48.30	30	557.08	1,114.80	557.00	371.47	135,585	3,254,037	2,645,520	808,517
Westmoreland	253.15	400.00	116.56	30	759.71	1,012.50	759.71	435.34	158,997	3,813,535	2,645,520	1,168,015
York	280.96	240.00	63.50	30	614.46	1,123.84	614.46	392.13	143,126	3,435,019	2,645,520	789,499
Landcaster	281.19	240.00	69.48	30	610.57	1,124.76	610.57	391.02	142,721	3,425,307	2,645,520	779,787
CAYC	219.30	280.00	75.08	30	584.38	877.20	584.38	340.98	124,462	2,887,096	2,645,520	341,576
Allegheny	206.95	400.00	127.38	30	784.33	827.80	784.33	382.74	143,351	3,440,419	2,645,520	794,899
Centre County	215.00	240.00	64.39	30	549.39	860.00	549.39	328.46	119,169	2,859,815	2,645,520	214,295
Delaware	317.91	220.00	54.89	30	622.80	1,271.84	622.80	419.54	153,132	3,576,177	2,645,520	1,029,657
Philadelphia	361.94	220.00	55.04	30	656.98	1,447.76	656.98	463.62	169,221	4,091,305	2,645,520	1,445,785

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* ALSO MEMBER NJ BAR
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November 5, 2007

VIA E-MAIL AND FIRST CLASS MAIL

Allen Warshaw, Esquire
Chief Counsel
Pennsylvania Department of
Public Welfare
Health & Welfare Building, 3rd Floor West
Harrisburg, PA 17120

RE: Draft Audit of PA ChildCare, LLC

Dear Mr. Warshaw:

In response to your letter of October 26, 2007, implicitly denying PA ChildCare, LLC's request for a meeting and granting it only until November 5, 2007 to respond to the Revised Draft Audit, PA ChildCare, LLC responds as follows:

1. PA ChildCare, LLC incorporates herein its March 8, 2007 response to the prior Draft Audit, including all of the exhibits thereto, as though set forth fully herein.
2. PA ChildCare, LLC incorporates herein the facts and arguments stated in my letter to you, dated October 26, 2007, including the exhibit thereto, as though set forth fully herein.
3. PA ChildCare, LLC incorporates herein the information and calculations regarding PA ChildCare, LLC's 2003 administrative expenses communicated to you and Kevin Friel by PA ChildCare, LLC Chief Financial Officer Patrick Owens at our meeting of October 23, 2006.

Allen Warshaw, Esquire
Chief Counsel
November 5, 2007
Page 2

4. PA ChildCare, LLC submits confidentially and under seal the 2004 Audited Financial Statements of PA ChildCare, LLC which includes the audited administrative expenses for 2004. This audited financial statement directly contradicts the Department's Revised Draft Audit at page 1 ("Based on available data for calendar year 2004, PACC was projected to have a profit of \$1.9 million on revenues of \$5.6 million or 34 percent"), at page 6 ("This has allowed PACC to generate . . . a projected \$1.9 million profit for calendar year 2004"), and the "assumptions" in Exhibit A to the Revised Draft Audit. Further, the 2004 audited financial statement supports the propriety of PA ChildCare, LLC's administrative expenses for 2003 which were determined through the same methodologies.

5. PA ChildCare, LLC takes exception to the Department's refusal to provide additional time for PA ChildCare, LLC to obtain additional documentation from its auditors regarding the acknowledgment, acceptance and approval of the procedures for calculation of its administrative expenses for 2003. Those procedures were the same procedures utilized and accepted in PA Childcare, LLC's audited 2004 financial statements.

6. PA ChildCare, LLC takes exception to the arbitrary and capricious actions and decisions of the Department in (1) treating PA ChildCare, LLC differently than its competitor Northwestern Human Services, (2) failing to give PA ChildCare, LLC adequate and timely notice of its objections to the additional financial documentation submitted on March 8, 2007, and (3) failing to give PA ChildCare, LLC sufficient opportunity to provide additional information after the Department's notice of its objections.

7. PA ChildCare, LLC takes exception to the arbitrary and capricious actions and decisions of the Department in rejecting PA ChildCare, LLC proffered administrative expenses for 2003 on the putative basis that it could only accept "audited" results while at the same time basing its own conclusions on the Department's "assumptions" about PA ChildCare, LLC's 2004 financials. Additionally, PA Childcare, LLC takes exception to the arbitrary and capricious actions and decisions of the Department in speculating as to PA ChildCare, LLC's 2004 financial results despite having never requested PA ChildCare, LLC to provide audited financials for 2004.

8. PA ChildCare, LLC takes exception to the arbitrary and capricious actions and decisions of the Department in using its audit to attempt to force PA ChildCare, LLC, a privately-held, for-profit corporation to sell its facility to Luzerne County.

9. PA ChildCare, LLC further wishes to supplement the record with the fact that the Department rejected a proposed agreement between PA ChildCare, LLC and Luzerne County to (1) amend the lease to an eight year term effective 1/1/08 to 12/31/15, thereby removing any question as to the whether the lease is a capital lease, (2) reduce by 12% the annual current gross

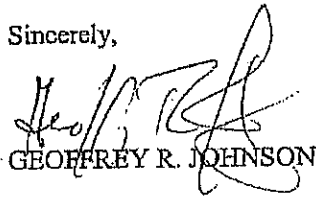
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Allen Warshaw, Esquire
Chief Counsel
November 5, 2007
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rent, and (3) work in good faith toward a sale in the short term of the facility utilizing the existing lease provision at Section 34 of the lease which specifically relates to County purchases of real estate.

I would appreciate your making this additional information available to Mr. Friel for inclusion in his audit. Thank you for your attention to this matter.

Sincerely,



GEOFFREY R. JOHNSON

GRJ/mw
Encl. (Confidential and Under Seal)

cc: Jonathan Vipond, Esquire (via e-mail and first class mail)
Robert J. Powell, Esquire (via e-mail and first class mail)
Gregory R. Zappala, Esquire (via e-mail and first class mail)