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November 13, 1984

P-429

Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 3151
Sacramento, California 95814

Dear Mr. Chairman and Members:

This letter is in response to a request for information on the State Department of Education's (department) termination and closeout of its contracts with the International Institute for Urban and Human Development (institute), a nonprofit corporation, and the department's monitoring of the financial stability of its contractors.

For over five years, the department contracted with the institute to provide child development services and subsidized meals to children of low-income families in San Diego, California. In February 1984, the department, through the Child Development Division and the Office of Child Nutrition Services, terminated the department's contracts with the institute and contracted with the San Diego YMCA to provide child development services for the children who had been enrolled in the institute's child development program.

In closing out its contracts with the institute, the department calculated how much the institute was still to be paid for child development services and subsidized meals. Based upon these calculations, we estimate that the department owes the institute \$4,585 for state-funded services. However, the institute owes the department \$40,236 for federally funded food programs. Thus, the institute owes the department a net total of \$35,651. The department is preparing to issue a final bill to recover outstanding funds.

According to the director of the Child Development Division, monitoring the financial stability of contractors was not standard practice before the department terminated its contracts with the institute. The director said, however, that he has implemented or will implement procedures to identify contractors having fiscal problems.

To gather information on the circumstances surrounding the department's termination of its contracts with the institute, the amount that the

Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
November 13, 1984
Page 2

institute owes the department, and the department's monitoring of contractors' financial stability, we interviewed officials in the Child Development Division, the Office of Child Nutrition Services, and the Audit Bureau. We also examined audit reports completed for the institute's child development contracts for fiscal years 1980-81 through 1982-83.

Termination of the Contracts With the Institute

Through the Child Development Division (division), the department contracted with the institute as early as fiscal year 1978-79 to provide state-funded child development services. This contract for \$100,406 was to provide services to an average daily enrollment of 51 children for 164 days of operation. For fiscal year 1983-84, the cost of the contract was \$194,652 to provide services to an average daily enrollment of 44.8 children for 252 days of operation. Since 1979, the institute has administered the child development program in licensed day care facilities rented from the San Diego Unified School District.

The Office of Child Nutrition Services has also had contracts with the institute to provide state and federally funded meals to the children of low-income families. According to available department records, the institute participated in the Office of Child Nutrition Services' food program as early as October 1976. The institute has purchased food through the United States Department of Agriculture's Commodity Program, administered by the department's Office of Surplus Property.

On February 2, 1984, the division learned that the San Diego Unified School District had secured a judgment against the institute for unpaid rent and utility payments and that it had demanded that the institute vacate the property used for its child development center. Because the institute had to remove its center from the school district's property, the division believed that the institute could no longer comply with the provisions of the child development contract requiring that services be provided only in a licensed child care facility. Therefore, on February 17, the division notified the institute that it was terminating the contract, effective February 24, 1984. The division's letter to the institute stated that the contract was being terminated in "consideration of the imminent danger created by your agency's violation of the health, safety, and welfare of the families served in the program." The Office of Child Nutrition Services also terminated its contract with the institute effective February 22, 1984.

Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
November 13, 1984
Page 3

The department asked the San Diego School District to allow the institute to remain in the facilities until February 24 so that the division would have sufficient time to arrange alternate child development services for the children enrolled in the institute's center. The San Diego Unified School District agreed, and the division contracted with the YMCA of San Diego to administer alternative services for the children beginning February 27. The YMCA program allows parents to select their own provider of child development services.

The Institute's Financial Condition and Outstanding State Funds

Although we did not analyze the institute's financial records during our review, we found evidence that the institute was experiencing serious financial problems before the department terminated the institute's contract. Audit reports for each of the three fiscal years preceding fiscal year 1983-84 indicate that the institute was financially insolvent each year because its liabilities exceeded its assets.

The institute also experienced cash flow problems during fiscal year 1983-84. In December 1983, the institute's bank did not honor employee paychecks because the institute did not have sufficient funds on deposit. While investigating employees' complaints about this problem, the division found that the State Controller had not sent the December funding check to the institute at the beginning of the month as it usually does. Consequently, the institute was unable to pay its employees until the State Controller sent the check later that month. Additionally, the institute had not made its monthly rent and utility payments to the San Diego Unified School District for 11 months. It was for this reason that the San Diego Unified School District took legal action to evict the institute from its licensed facility. According to the school district's legal counsel, the school district will take legal action against the institute to obtain payment for over \$13,000 in unpaid rent and utility payments.

Additionally, the department's Local Assistance Bureau informed the institute on January 18, 1984, that, in accordance with the terms and conditions of the division's child development contract, the Local Assistance Bureau was withholding the institute's February 1984 funding check because the institute had failed to submit its required audit report for the 1982-83 fiscal year contract. On January 30, 1984, the Local Assistance Bureau informed the institute that it would also withhold the March 1984 apportionment unless the institute submitted

Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
November 13, 1984
Page 4

the audit report. Finally, the Secretary of State suspended the corporate status of the institute effective March 1, 1984, because the institute failed to file its required tax returns with the State Franchise Tax Board.

On February 8, 1984, the department's staff counsel instructed the division to withhold any further payments to the institute until the department could closeout the institute's contracts with the division and the Office of Child Nutrition Services and determine whether the institute owed the department any funds. As of October 17, 1984, the department had not completed its final accounting of the institute's outstanding funds. However, the department's Audit Bureau has completed a review of attendance to determine the institute's average daily enrollment and days of operation from July 1, 1983, to February 22, 1984. The Audit Bureau used the total days of operation to estimate how much the institute should be reimbursed for child development services under the fiscal year 1983-84 contract. In addition, the Audit Bureau made recommendations that would determine the reimbursements for fiscal years 1981-82 and 1982-83. The Audit Bureau also made recommendations based on its final review of the food service contracts between the institute and the Office of Child Nutrition Services since October 1979.

Based upon our review of the Audit Bureau's reports and recommendations to closeout the contracts between the department and the institute, we conclude that the department owes the institute an additional \$4,585, payable from state funds, for child development services and meals that the institute provided until February 24, 1984. At the same time, however, the institute owes the department \$40,236 for federally funded food programs. Of this amount, the institute owes \$39,351 for federal funds that the Office of Child Nutrition Services advanced to the institute and overpaid on claims made pursuant to food program contracts. The institute owes the department the remaining \$885 for purchases that it made from the Federal Commodity Program through the department's Office of Surplus Property. The net result is that the institute owes the department \$35,651. Table 1 below shows the amounts that the department owes the institute and the amounts that the institute owes the department. The table also indicates the programs that these amounts are related to and whether they affect state or federal funds.

Honorable Art Agnos, Chairman
 Members, Joint Legislative
 Audit Committee
 November 13, 1984
 Page 5

TABLE 1

**ESTIMATED AMOUNT OF FUNDS THAT
 THE INTERNATIONAL INSTITUTE OF URBAN
 AND HUMAN DEVELOPMENT OWES THE
STATE DEPARTMENT OF EDUCATION**

<u>Agency/Contract Period</u>	<u>Federal Funds</u>	<u>State Funds*</u>	<u>Total</u>
<u>Child Development Division</u>			
Fiscal Year 1981-82		\$ 2,973	\$ 2,973
Fiscal Year 1982-83		(4,296)	(4,296)
July 1, 1983 to February 24, 1984		(2,703)	(2,703)
<u>Office of Child Nutrition Services</u>			
Advance Outstanding April 1, 1979 to September 30, 1981	\$30,842		30,842
October 1, 1981 to January 31, 1984	4,625	(444)	4,181
	3,884	(115)	3,769
<u>Office of Surplus Property</u>			
Fiscal Year 1982-83	<u>885</u>	<u> </u>	<u>885</u>
Total	<u>\$40,236</u>	<u>\$(4,585)</u>	<u>\$35,651</u>

*Parentheses indicate the amount of funds that the State Department of Education owes the institute.

Our estimates in the above table are based upon information provided by the department's Audit Bureau and Accounting Office. The department's staff counsel has requested that the Audit Bureau prepare a final reconciliation, indicating that the department may issue a single bill

Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
November 13, 1984
Page 6

to the institute for the net amount owed to the department. The amount that the institute owes the department may change if the institute successfully appeals the findings and recommendations of the Audit Bureau.

On February 2, 1984, the institute's executive officer filed for personal bankruptcy under Chapter 7 of federal bankruptcy laws. The court's appointed trustee is in the process of selling all appropriate assets with cash value. Once the sales are complete, the trustee will identify valid creditors and liquidate the executive officer's personal debts. However, the institute has not filed for corporate bankruptcy. According to the department's staff counsel, the institute is still responsible for the debt to the department, and the staff counsel intends to file a claim with the bankruptcy court so that the department will be recorded as a creditor should the trustee liquidate the institute's debts along with the executive officer's personal debts. The staff counsel also believes that this action will keep the department informed of the institute's ability to repay its debt. The staff counsel indicated that it may take "considerable time" to collect the outstanding funds and close the department's account with the institute.

Monitoring Activities of the Child Development Division

The director of the division stated that the division did not monitor the financial stability of contractors as a standard practice in the past. However, the director told us that, in an attempt to reduce fiscal liability to the State, he has implemented or is in the process of implementing procedures to identify contractors that have fiscal problems. For example, the division will now review audit reports for the previous fiscal year to determine the financial status of a contractor before developing the funding provisions for the subsequent fiscal year. The division is also implementing procedures that will allow it to examine the financial status of entities bidding for new contracts. Additionally, the director is revising the contract funding terms and conditions to ensure better fiscal control. Finally, the director is initiating several studies including a review of the cost of services, common fiscal problems among contractors, and alternatives to the existing reimbursement system for contractors.

The director believes that current statutes do not allow him to terminate contracts immediately solely because of a contractor's financial mismanagement. According to the director, he may only terminate a contract immediately if he can demonstrate that the

Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
November 13, 1984
Page 7

financial conditions present an imminent danger to the health and safety of the children whom the contractor serves. Until he can seek authority to terminate contracts immediately for financial reasons alone, the director believes that his new procedures will allow the division to identify current contractors that have fiscal problems and to ensure that prospective contractors are financially stable before the division issues contracts to them.

We have asked the department to keep us informed of its progress in closing the accounts with the institute. We will report again to the Legislature when the department takes its final action on the institute's account.

We conducted this review under the authority vested in the Auditor General by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the first paragraph of this letter.

Sincerely,



for THOMAS W. HAYES
Auditor General

cc: Assemblywoman Sunny Mojonnier