



Office of Multnomah County Auditor

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County Auditor

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Date: March 17, 2015

To: Deborah Kafoury, Multnomah County Chair
Marissa Madrigal, Chief Operating Officer
Liesl Wendt, Department of County Human Services Director

From: Steve March, County Auditor
Mark Ulanowicz, Principal Management Auditor
Annamarie McNiel, CPA, Senior Management Auditor

Subject: Report to Management, Large Contracts Financial Health Monitoring
Follow-up

Summary

The purpose of this letter is to communicate the results of our follow-up on a recommendation regarding financial health monitoring from our Management of Large Contracts audit report. We found that the financial health monitoring function has largely remained unchanged since the audit. As noted in the report, the County's contracting lacks consistent and organization-wide contract administration controls (such as financial health monitoring). This lack of adequate system-wide controls does not necessarily lead to contracting failure. However, it does increase the risk that the County will not be prepared to recognize or act on vendor performance problems, or protect its assets and its clients. In addition, we found that the County is not consistently informing its contractors that they are receiving federal funds – another important contract administration control. This increases the risk that these contractors will not be in compliance with federal rules and laws governing the use of these funds.

Background

The objectives of the Management of Large Contracts audit was to check the status of contracting-related recommendations from prior audits and to identify potential areas of risk and concern in Multnomah County's management of large contracts. With a large and important part of the County's business conducted via contracts, careful contract management should be a high priority.

During the original audit, we identified several weaknesses in the contract administration functions at the County. One of the issues we identified was the lack of formalized monitoring of contractor financial health for high risk contracts (those with the greatest risk to clients or the County in the event of a contractor failure). In 2008, we recommended that the County formalize and expand the financial health monitoring program, strengthen contract monitoring systems by adapting best practices already found elsewhere in the County, strengthen evaluation systems and clarify appropriate formal evaluation methods.

Contract administration and monitoring is primarily the responsibility of the departments and divisions that house the associated programs. However, the Department of County Management's fiscal compliance unit is responsible for monitoring the extent to which contractors receiving federal funds follow federal rules. This compliance function is distinctly different from financial health monitoring, which focuses on financial performance and an organization's ability to fulfill its obligations.

Changes to federal requirements are coming that will impact the County directly as they relate to County contractors that are paid using federal funds. The financial health of these contractors (commonly called sub-recipients) is one component of a larger evaluation of risk that will be required. These changes will be effective for the County as of July 1, 2015.

Audit Results

Finding 1: Lack of Expanded Financial Health Monitoring

We found that the financial health monitoring practices have not changed significantly since the Audit report was issued. Monitoring financial health can be as simple as reviewing vendor financial statements and calculating a series of standard financial ratios – to be compared to common industry targets. These ratios can provide some insight into financial health issues such as a vendor's ability to pay its bills or cover short-term fluctuations in revenue.

A more robust financial health review would include identifying benchmark financial ratios from peer group organizations. We performed this sort of financial benchmarking analysis for five of the County's largest human service providers. We focused on the human service providers due to the large amount of funding passing through to these

contractors. The five contractors in the analysis are Cascadia Behavioral Healthcare, Inc., Central City Concern, LifeWorks Northwest, Luke-Dorf, Inc., and Morrison Child and Family Services.

The financial ratios we calculated for the five contractors were generally in line with the benchmark peers and common industry targets. Yet, each of the five contractors some level of heightened risk in their financial health, such as limited levels of cash on hand, higher levels of debt, higher concentrations of revenues and/or low levels of net income. Part of this is expected given that the entities are non-profit organizations serving low income, vulnerable populations. There were a couple of areas that show lower than expected performance. In particular we noted that the days of cash on hand for all entities is well below the common target of 90 days and four of the five entities are even below the peer group's median of 32 days. This may be an indicator that the organizations are running very lean and may struggle to meet ongoing operations if they have any significant changes in resources (revenue) or operation costs. The results of our analysis for selected financial ratios are outlined in Appendix A.

In addition, with the upcoming changes to federal requirements the County will be required to evaluate each sub-recipient's risk of noncompliance with Federal statutes, regulations, and the terms and conditions of the sub-award (Title 2 of the Code of Federal Regulations (CFR), §200.331 (b)). These requirements are consistent with the conclusions and recommendations from our Audit of Large Contracts – that contracts and contractors that pose the greatest risk to the County and its clients should be subject to a higher degree of scrutiny.

Finding 2: Missing Contract language

During our follow-up review we became aware that the County needs to improve its practices for notifying contractors when they are receiving federal funding passing through the County.

We identified inconsistencies in how and when the County notifies its contractors that they are receiving federal funding associated with a contract and/or when the funding source changes subsequent to the initially executed contract. This notification is critical because it lets contractors know that they are responsible for additional requirements under federal laws and regulations as they relate to specific funding sources. It is important that this notification occur on a timely basis when the funding source is first identified or changes. This helps contractors meet compliance requirements as soon as possible and reduces the likelihood of noncompliance.

Notifying contractors about federal funding sources is also a legal requirement. As noted in the Office of Management and Budget's Circular A-133, the County's responsibilities as a pass-through entity include informing each subrecipient of the CFDA (Catalog of Federal Domestic Assistance) title and number, award name and number, award year, if the award is research and development (R&D), and name of

Federal agency (per Section 400(d)). These specific requirements are also being revised and expanded based on the upcoming federal requirements (CFR Title 2, §200.331 (a)).

It is the County's practice to meet this requirement through the use of boilerplate language within the governing contract. The notification of federal awards to the contractor is typically met utilizing a paragraph within the contract's Statement of Work (Section II E. – Federal Funds Audit Requirements). The section references A-133 audit requirements and includes the CFDA number and Program Title of the associated federal funds. When no federal funds are used, the contract specifies that the requirements do not apply. The inclusion of this information into a boilerplate exhibit was the result of the external auditor's recommendation from the fiscal year 2009 audit.

Although including this paragraph is standard practice, departments do not always apply it correctly. We identified a contractor that received federal funding as part of the initial contracting and while the contract had the updated boilerplate language it incorrectly indicated that federal funding information was *Not Applicable*.

In another case, we identified a contract that had a change in funding which added federal funding to the resources. Neither the County-drawn primary contract nor the amendments identified the specific funding as federal, no CFDA number was listed, and the County provided no notice of the additional federal compliance requirements. This resulted in the contractor not being aware that the funds were federally sourced and subject to federal compliance requirements. As a consequence, the contractor did not have the information needed to accurately report on the federal funds to the Federal Audit Clearinghouse for the associated year, as required.

Recommendations

1. It is our repeated recommendation that financial health monitoring be expanded and include a formalized review process of the contractor's financial health. We recommend the expanded review be based on a risk-based approach.
2. We recommend that the risk evaluation of subrecipients be performed prior to contracting with a subrecipient to ensure that contract language is tailored adequately to address any risks identified and so that appropriate requirements are included in the contract language with sufficient criteria to meet the upcoming federal policy changes in CFR Title 2, §200.
3. We recommend that the County expand policies and procedures to outline a financial health monitoring process to include what is expected to be communicated, to whom it is to be communicated, and a general procedure outlining steps to take when risks are identified. It is our recommendation that when risks are identified, the process should include, at a minimum, notification to the County Chief Operating Officer, written acknowledgement of the risk, the

acceptance of the risk, description of why the risk is being accepted and what is being done to mitigate and monitor the risks.

4. It is also our recommendation that each department involved with passing through federal funding to contractors improve their process to include the required information in the contracts when federal funding exists and issue amendments to the contracts as soon as a change in funding becomes known. This process could be strengthened through policy and process improvements as well as training for departmental staff.

Scope and Methodology

We performed interviews, reviewed contracts and performed a fiscal benchmarking analysis as well as other document review in order to assess the progress made on financial health monitoring.

We performed our fiscal benchmarking analysis on five of the County's largest mental health service providers using 2012 audited financial statements, as these were the most readily and consistently available statements for the group and their peers at the time of analysis. For benchmarking we obtained comparable entities audited financial statements. We selected six comparable entities as the peer group. They were selected based on them being non-profit organizations, the geographic region served (Pacific Northwest), the level of resources (total revenue between \$10 million and \$60 million), and target mission (includes mental health services). We used professional judgment to calculate some of the financial ratios due to varying presentations of financial statements among entities. Specifically, we used judgment in classifying assets and liabilities between current and non-current when the balance sheet was presented on an unclassified basis.

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

cc: Karyne Kieta, Department of County Management Deputy Director, Budget Director
Mark Campbell, Chief Financial Officer
Joanne Fuller, Health Department Director
Scott Taylor, Department of Community Justice Director

APPENDIX A
Benchmarking Analysis Results

Below are a few selected financial ratios from the benchmarking analysis performed over five of the County's largest mental health providers. The analysis was performed using 2012 audited financial statements as these were the most readily and consistently available statements for the group and their peers at the time of the analysis. For benchmarking we obtained six comparable entities audited statements for the peer group. Comparable entities were based on being a non-profit organizations, their geographic region of service (Pacific Northwest), level of resources (total revenue between \$10 million and \$60 million), and target mission (includes mental health services).

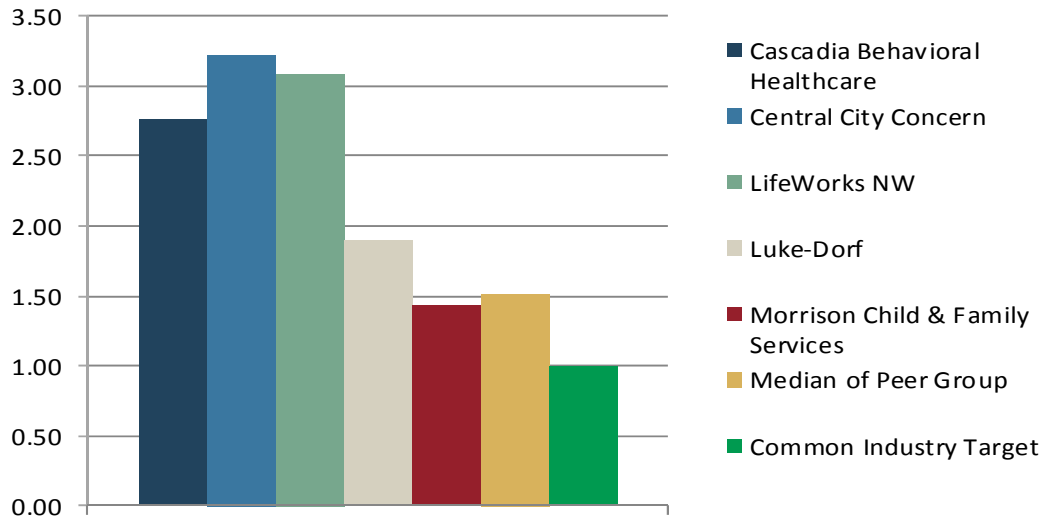
Current Ratio

Calculation: Current assets divided by current liabilities.

What it tells us: This is a liquidity ratio. It is an indication of the entities' ability to meet short-term obligations.

Common industry target: Equal to or greater than 1.0.

Exhibit 1. Current Ratio for Mental Health Providers



Source: Auditor's Office

Results: All entities are performing at or within the industry target range as well as being comparable to their peers.

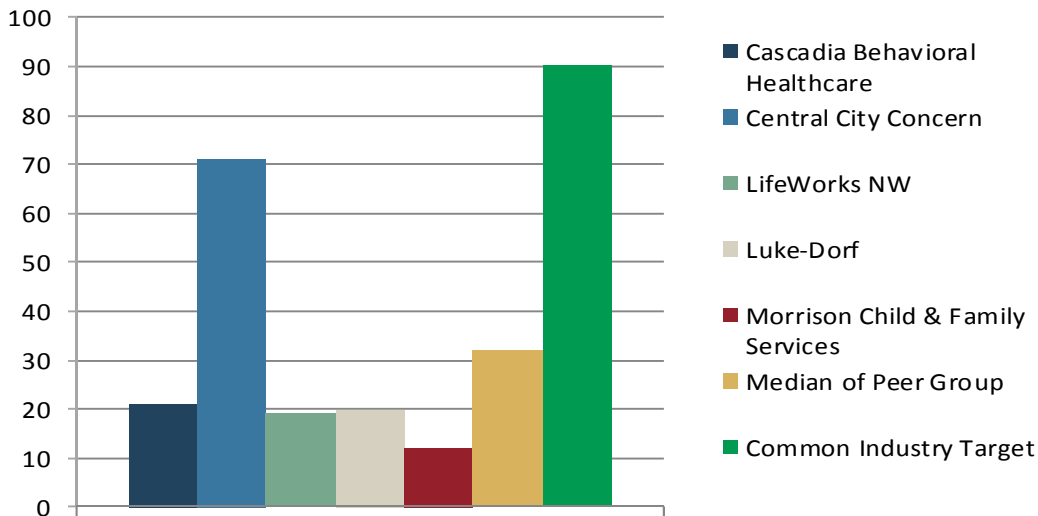
Days Cash on Hand

Calculation: The sum of cash and marketable securities divided by the daily cash required (total expenses minus depreciation, non-cash expense, and pass-through expenses divide the sum by 365).

What it tells us: Measures the number of days an organization can operate without having to tap into other assets.

Common industry target: Equal to or greater than 90 days.

Exhibit 2. Days Cash on Hand for Mental Health Providers



Source: Auditor's Office

Results: All entities are below the common target zone and all, except for Central City Concern, are lower than the median of their peer group. This may indicate the organizations are running very lean and may struggle to meet ongoing operations if they have any significant changes in resources (revenue) or if costs of operations increase significantly with no corresponding increase in resources.

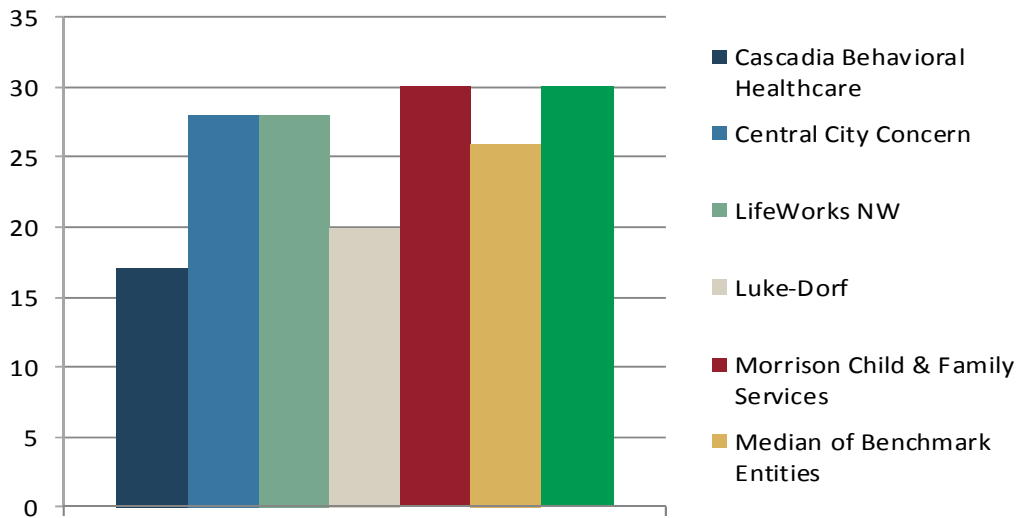
Days Payable

Calculation: Sum of accounts payable and accrued wages divided by total expenses times 365.

What it tells us: Indicates the average number of days it takes the entity to pay its expenses.

Common industry target: 30 days or less; indicates bills are being paid in a timely manner (in the normal 30 day cycle).

Exhibit 3. Days Payable for Mental Health Providers



Source: Auditor's Office

Results: All entities are performing at or within the industry target range as well as being comparable to their peers.

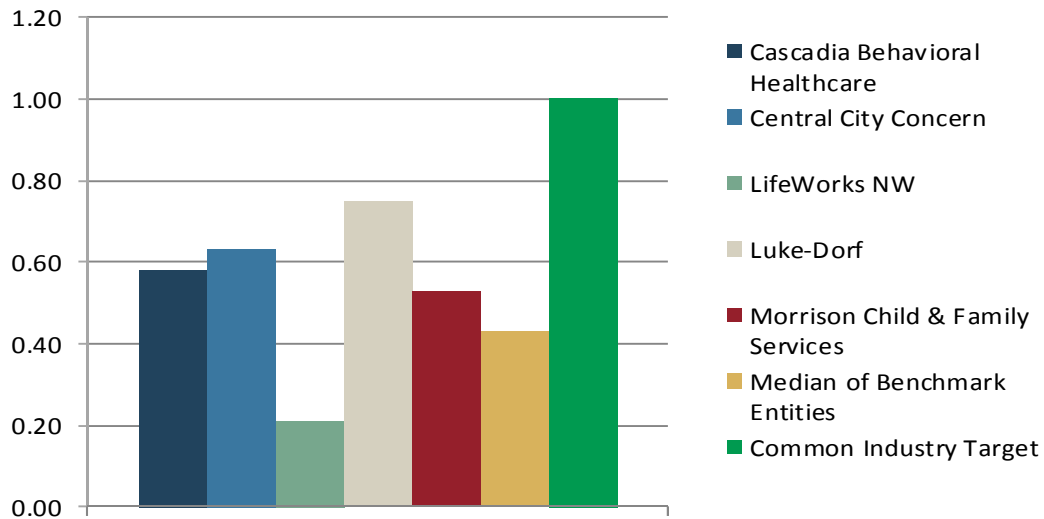
Debt Ratio

Calculation: Total debt divided by total assets.

What it tells us: This is an indication of how much the entity relies on debt to finance assets.

Common industry target: Equal to or less than 1.0.

Exhibit 4. Debt Ratio for Mental Health Providers



Source: Auditor's Office

Results: All entities are performing within the industry target range. However, all except for LifeWorks show that they are more leveraged than the median of their peers. This may indicate low borrowing capacity of an entity, which in turn could lower the entity's financial flexibility.

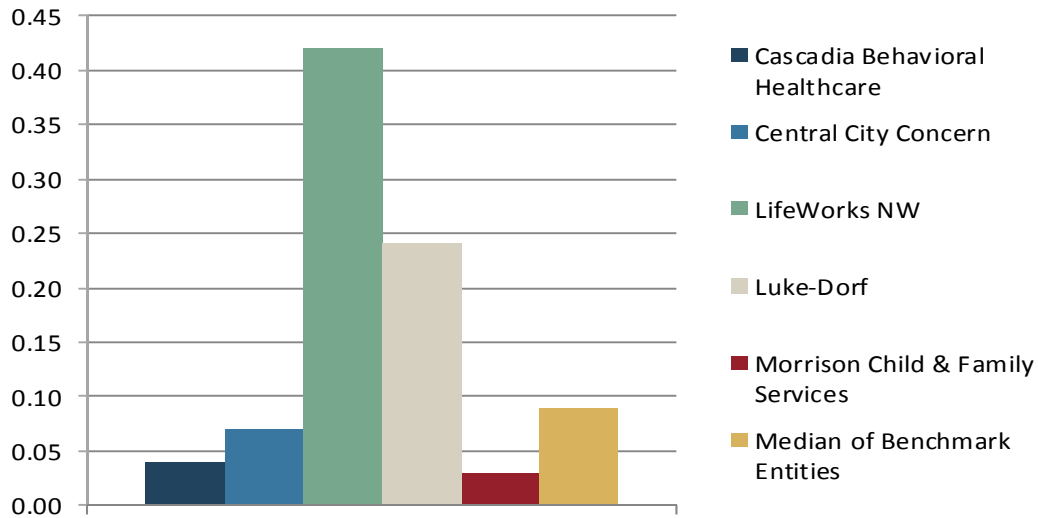
Grants & Contract Income to Total Income Ratio

Calculation: Sum of grant and contract income divided by total income.

What it tells us: An indication of an entity's reliance on a specific type of revenue/resource. A high level of reliance indicates a concentration and may pose a risk.

Common industry target: No specific common industry target identified; the lower the ratio the less reliance on a specific resource generally indicates less risk.

Exhibit 5. Grants & Contract Income to Total Income for Mental Health Providers



Source: Auditor's Office

Results: All entities are performing within a comparable range to their peers with the exception of LifeWorks and Luke-Dorf who have a higher concentration of resources (revenue) being provided through grants and contracts (42% and 24%, respectively). This could indicate a risk to LifeWorks and Luke-Dorf to function at capacity if it is unable to continue to secure these resources or if there is a significant change to the level of this type of funding.

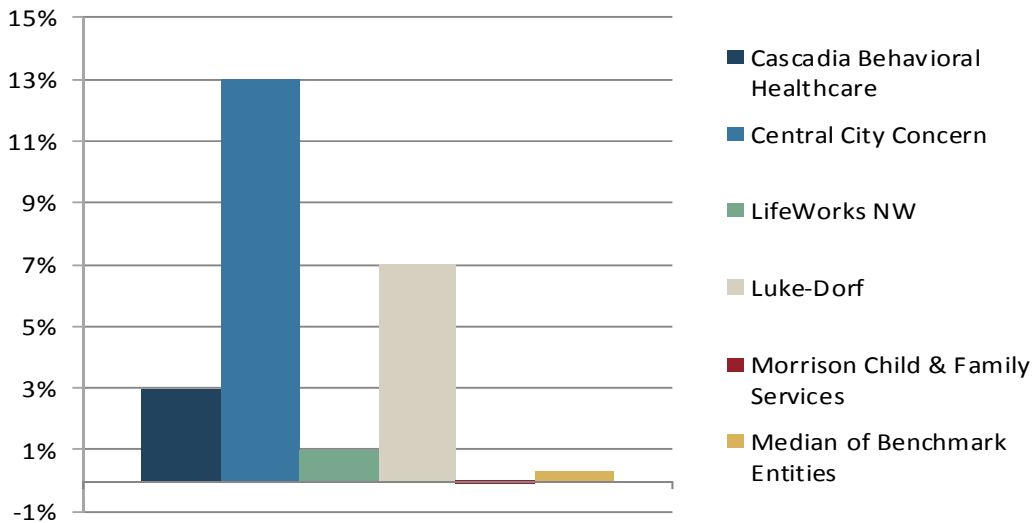
Income Margin

Calculation: Sum of total revenues less total expenses divided by total revenues.

What it tells us: In general, low income margins could suggest an organization is struggling to meet on-going operations and/or struggling to build reserves. Income margins vary greatly between companies and industries.

Common industry target: No specific common industry target identified.

Exhibit 6. Income Margin for Mental Health Providers



Source: Auditor's Office

Results: This ratio is an indication of the entity's ability to manage expenses in relation to resources received. Given the entities are non-profits working with limited resources and rising costs of doing business, the expectation is that these ratios could be very low and possibly very close to breakeven. However, the entity should have a strategy that aligns with their mission; further, building reserves is an effective way to achieve this.

All entities are performing within a comparable range or better compared to their peers with the exception of Morrison Child & Family Services (Morrison). Morrison appears to be performing just below a breakeven point at <0.1%> to pay for operations. This could indicate that Morrison has to tap into reserves (net assets) to pay for operations. For Morrison, we looked at prior audited financial statements as well (fiscal years 2012, 2011, 2010 and 2009). The net income to total revenues has been -0.14%, 1.11%, 3.17%, & -4.66% for 2012, 2011, 2010 and 2009, respectively. This indicates that Morrison is struggling to build reserves over the past several years and may be required to tap into reserves (net assets).

Additionally, LifeWorks appears to be performing at just above the breakeven point at 1%. This could indicate that LifeWorks is struggling to build reserves.

Department of County Management



Office of the Chief Operating Officer

501 SE Hawthorne Blvd Ste 600, Portland, Oregon 97206

March 17, 2015

Auditor Steve March
501 SE Hawthorne Blvd, Ste. 600
Portland, Oregon 97206

Dear Auditor March:

Thank you for the opportunity to review and respond to your follow-up report on Large Contracts Financial Health Monitoring. As we know from past experience in our own community and non-profit collapses across the country, disruptions in service due to poor financial management can have a disproportionate impact on vulnerable populations. We appreciate your attention to this issue and agree with your assessment.

Currently, departments are responsible for monitoring the fiscal health of all large contract holders regardless of funding source. However, the Fiscal Compliance Unit within the Finance & Risk Management division conducts ad-hoc vendor risk assessments upon request. In order to respond to both the new federal "super circular" and some of the risks identified in your report, the Fiscal Compliance Unit is doing the following:

- 1) Developing a process for completing up-front risk assessments on all human service contracts.
- 2) Developing additional financial health monitoring procedures to identify and track high risk/high impact human services vendors.

Up-front Assessments & Federal Requirements

Fiscal Compliance is developing a process for completing up front risk assessments for all human services contracts to comply with changes detailed in the new federal "super circular" which takes effect on July 1, 2015. We are building a risk assessment tool and procedures that will detail risk components, responsible parties, risk acceptance, and risk mitigation steps.

The upcoming changes in federal regulations will also require the County perform a risk assessment for all sub-recipients. This is designed to assess the risk that those vendors are out of compliance with federal statutes and regulations. The Fiscal Compliance Unit is currently in the process of developing a risk assessment tool that covers the needed components detailed in the new federal requirements and will work with applicable departments to implement changes and develop a policy for reporting results.

We also agree with the recommendation that including comparable financial benchmarking for peer group organizations would greatly improve the financial health review process. To that end, the Fiscal Compliance Unit is implementing more robust financial benchmarking in its annual review process. In addition, we will be developing a formal process for assessing risk for ongoing human services contracts. This risk assessment will look at financial risk (i.e., financial statement review) and administrative risk (i.e., Board of Directors involvement). The procedure will establish risk assessment tools, review frequency, responsible parties, communication process, steps to mitigate risk, and steps to accept high risk. When completed, this procedure will be presented to the Operations Council and approved by the Chief Financial Officer and Chief Operating Officer.

Thank you again for your thoughtful and timely recommendations. As you can see, we are well on the way to implementing them and we anticipate that new processes and procedures will be in place prior to the implementation date of the federal "super circular".

Sincerely,



Marissa Madrigal
Chief Operating Officer