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**OFFICE OF THE
NEW YORK STATE COMPTROLLER**

DIVISION OF STATE SERVICES

**RESEARCH FOUNDATION
FOR MENTAL HYGIENE,
INC.**

**INTERNAL CONTROLS
OVER REVENUE AND
PROCUREMENT**

Report 2005-S-7

AUDIT OBJECTIVES

Our audit objectives were to determine whether the Research Foundation for Mental Hygiene, Inc.'s. (Foundation) Board of Directors (Board) is fulfilling its legal and fiduciary obligations, and whether the Foundation has instituted appropriate internal controls over revenue and procurement operations.

AUDIT RESULTS - SUMMARY

Overall, we found the Board is fulfilling its legal and fiduciary obligations, and the Foundation's internal controls over revenue and procurement operations are functioning as intended. However, we identified several improvement opportunities:

- The Board would benefit by having more Board members with a background independent of the mental hygiene field.
- Board members on the audit committee should not be the same individuals serving on the finance committee.
- The Foundation's administrative office at the Institute of Basic Research has not adhered to certain controls for the procurement of goods or services.

- Custodians over equipment should not also be responsible for the physical inventory process.
- The Foundation's administrative offices at the State research institutes need to update their inventory records when equipment is moved, loaned or transferred.
- Policies and procedures need to be developed and implemented over certain revenue and procurement functions.

Our report contains seven recommendations to improve Board governance and controls over revenue and procurement. Foundation officials generally agreed with our recommendations.

This report, dated July 19, 2006, is available on our website at: <http://www.osc.state.ny.us>. Add or update your mailing list address by contacting us at: (518) 474-3271 or
Office of the State Comptroller
Division of State Services
State Audit Bureau
110 State Street, 11th Floor
Albany, NY 12236

BACKGROUND

The Foundation was established in August 1952 as a non-profit corporation to assist the Department of Mental Hygiene agencies - Office of Mental Health, Office of Mental Retardation and Developmental Disabilities, and Office of Alcoholism and Substance Abuse Services - in the administration of grants and sponsored research for New York State. The Foundation also handles special projects for the Department of Mental Hygiene, such as information systems development and operational needs assessments. Headquartered at the Riverview Center in Menands, New York, the Foundation is governed by a Board of 21 scientists, administrators and State government officials.

The Foundation assists the State research institutes in the procurement and administration of grant funds from federal and non-federal organizations. Most of the grant-related research activity takes place at three State research institutes: the New York State Psychiatric Institute, located in New York City; the Nathan S. Kline Institute for Psychiatric Research, located in Rockland County; and the Institute for Basic Research in Developmental Disabilities, located in Staten Island. The institutes employ research scientists and technical specialists, known as Principal Investigators (Investigators). The Investigators are responsible for identifying and applying for research grants, performing the research in compliance with grant requirements, and monitoring the progress of work. These Investigators are State employees. In addition, the Foundation employs about 1,600 individuals who provide direct support for scientific research conducted by the Investigators. Foundation staff are not State employees, do not receive State benefits, and do not participate in State retirement programs.

For the 2003-04 State fiscal year, the Foundation had grant and other revenue totaling more than \$148 million. About 80 percent of the Foundation's grant revenue consists of federally-funded grants principally through the National Institutes of Health. The remaining grant revenues are derived from privately-funded, non-profit, and State grant initiatives. As the grant recipient, the Foundation is legally responsible for the appropriate use of funds and for the performance of the grant-supported projects or activities.

AUDIT FINDINGS AND RECOMMENDATIONS

Board Governance

We assessed whether the Foundation's Board is fulfilling its legal and fiduciary obligations and whether improvements are possible. To help in our assessment, we reviewed the Foundation's By-Laws, which were revised in January 2005. The By-Laws define the responsibilities of the Board and its various committees, and set forth the general operating principles for conducting Foundation affairs. We also reviewed the Model Governance Principles for Authorities (Model Principles), which were issued by the Governor's Office in 2004 to help improve oversight, accountability, and transparency at the State's public authorities. The Model Principles were based on the "best practices" of corporate governance used in the private sector as well as requirements of the federal Sarbanes-Oxley Act of 2002. While the Sarbanes-Oxley Act was aimed primarily at publicly traded corporations, some industry groups maintain that non-profit organizations are also under increasing pressure to examine their governance principles to ensure their boards of directors adequately protect the interests of their constituents.

The Board should serve as an objective body for monitoring management activities. According to the Model Principles, to do this, Board members should be independent from the entity they serve. Accordingly, Board members should not be part of management nor receive any compensation from the entity. Our review of ten Board meetings for the period May 2002 through January 2005 found the Board, in general, performs its function of monitoring management's activities. However, the Board lacks independence, has not received training in certain key areas, and needs to improve attendance at quarterly meetings.

The Foundation's By-Laws allow the Board membership to be comprised of officials or employees of the Department of Mental Hygiene agencies, senior level Foundation officials and officials from entities involved in mental hygiene research. We found that 17 (81 percent) of the 21 Board members are either Foundation employees or employees of the Foundation's major contractor - the Department of Mental Hygiene. As a result, these 17 individuals who set the Foundation's long-term mission in their capacity as Board members also participate in the Foundation's daily activities, resulting in a lack of independence. We noted that only four Board members are independent. Three of them (known as at-large members) are not required by the By-Laws to attend Board meetings for purposes of achieving a quorum to conduct business. In fact, for the ten Board meetings we reviewed, two at-large members each attended just one Board meeting and the third at-large member never attended a Board meeting. The other independent member is from the private sector. Therefore, 17 (94 percent) of 18 Board members attending most of the meetings we reviewed were either Foundation or Department of Mental Hygiene employees.

In addition, according to the Model Principles, the Board's audit committee should be comprised entirely of independent Board members who do not have a financial interest in or any other conflict of interest with any entity doing business with the Foundation. The audit committee is directly responsible for hiring, setting compensation and overseeing the activities of the Foundation's independent auditor. It is also responsible for resolving any discrepancies or differences regarding accounting and internal control practices between the independent auditor and the organization's financial managers who prepare the financial statements. The audit committee members should also be separate from the finance committee membership, which advises the Board on fiscal, budgetary and investment matters. We found that the Foundation's audit committee membership is comprised of those who have a significant role in the Foundation's management. In addition, three of the six members that comprise the audit committee are part of the eight-member finance committee. The audit committee's lack of independence could affect its ability to properly fulfill its responsibilities.

We did not observe any inappropriate transactions or activities during our audit of the Foundation. However, we believe that Board governance would benefit if Board members were more independent and had backgrounds not primarily limited to the mental hygiene field. A Board comprised of independent individuals could help foster an environment of openness and transparency, and reduce the appearance of a potential conflict of interest. Foundation officials stated that the Board, prior to adopting changes to the By-Laws in January 2005, discussed the issue of Board independence and concluded that the Board members are sufficiently independent to ensure there are no conflicts in carrying out their obligations.

However, the officials agreed to consider this issue, but indicated it may be difficult to recruit people from other backgrounds who would be willing to serve on the Board.

In addition, the Model Principles state that Board members should receive appropriate training regarding their legal, fiduciary and ethical responsibilities. This topic was discussed at the September 2004 Board meeting, when a Board member offered to contact a firm he was familiar with to provide such training. Although we fully support Board training, we believe services should be obtained from the most qualified providers as determined through a fair and objective procurement process. Foundation officials stated that Board training was held in March 2006, 17 months after initially discussing the need for such training.

We also noted that the Foundation's By-Laws do not directly address and define ethical behavior. Instead, they reference the Foundation's Corporate Policy Manual, which subsequently references the Association for Investment Management and Research Code of Ethics. We did not note unethical behavior during our audit and in fact identified instances where positive action was taken. For example, the Board revised the investment policy to add pharmaceutical companies to the Foundation's list of prohibited investments. We believe this is an ethical approach to investing as it removes a potential conflict of interest. Nevertheless, we believe the Foundation's By-Laws need to directly address and define ethical behavior for Board members to prevent any unintentional misunderstanding.

Although a quorum was present at all ten meetings we reviewed, overall the Board only averaged 63 percent of members in attendance. In addition to the absence of the three at-large members, a pattern of non-

attendance was found for another Board member. Although the lack of attendance did not prevent the Board from conducting business and fulfilling its fiduciary and legal obligation, we believe the spirit and intent of having a 21-member Board is not achieved with an absenteeism rate of 37 percent. In addition, absenteeism is detrimental to the continuity of important discussions and decisions. Foundation officials believe the Board is effective, based on the Board's 53 year record of making sound financial and operational decisions, and that a quorum (10 of the required 18 members attending or 55 percent) have been present at all Board meetings for the last ten years. However, officials stated that they constantly strive to improve attendance.

Recommendations

1. The Foundation's Board should revise its By-Laws to improve the number of members who are independent and to provide for a code of ethics.
2. The Foundation's audit committee members should not be the same members serving on the finance committee.
3. The Foundation should improve attendance at quarterly Board meetings.

Revenue and Procurement

Procurement

To test controls over procurement, we selected a sample of 50 purchase orders for office supplies, consulting services, food for research subjects and personal computers with a total value of more than \$2 million. Our testing did not identify any unauthorized or inappropriate purchases. However, we found improvement opportunities at the Institute of Basic Research (Institute).

To meet their needs, the Investigators or their designees working at the institutes place orders for goods and services through the Foundation's administrative offices located at these sites. The administrative office is required to verify that the person making the purchase request is authorized to purchase items for a particular Investigator's research grant. In addition, the administrative office is required to ensure that funds are available for the purchase and that the purchase is appropriate and within the grant's guidelines.

We found that, at the Institute, the Foundation's administrative office can do a better job of verifying whether the person initiating the purchase request is authorized to do so and of ensuring purchases meet the grant's guidelines. Officials at the Institute told us that if funding exists to support the items being purchased, they assume the purchase is appropriate and within the grant's guidelines. They do not verify that procurements comply with the guidelines. They also cited the small size of the Institute as enabling the Foundation's administrative office to informally know who is authorized to incur expenses for each grant. However, not following established procedures increases the risk that purchases can be made that are unauthorized and unrelated to the research grant. After the research is completed and the grant is audited by the grantor, these expenses could be disallowed for reimbursement.

Recommendation

4. The Foundation's administrative office at the Institute should ensure compliance with procedures for verifying whether purchases for goods or services are authorized and meet the grant's guidelines.

Equipment Inventory

The Foundation has 27 locations across the State to provide support services, such as training for the Department of Mental Hygiene. The Central Office maintains the equipment inventory records for these locations. However, when physical inventories are taken, the Foundation does not have an independent confirmation of assets on hand. The custodians over the equipment are the ones who confirm the equipment's physical existence. An independent physical inventory check of these items is needed to reduce the risk of potential fraud or abuse.

In addition, we tested the equipment inventory controls at the three research institutes by judgmentally selecting a sample of 82 items particularly vulnerable for abuse, theft or personal use, such as laptop computers, printers, digital cameras and video recorders. Although we were able to confirm the existence of these items, 15 (18 percent) were not at their correct location as stated in the official inventory list. This was due to Investigators moving items from room to room, or lending an item to another Investigator without reporting the change to the Foundation's administrative office at the institute. Investigators are required to notify the Foundation's administrative office when equipment is being moved, lent or transferred to another Investigator to maintain accurate equipment records.

Recommendations

5. The Foundation should conduct independent physical inventories of equipment and durable supply inventories.
6. Foundation Investigators should notify the Foundation's administrative offices at the institutes when they move, lend or transfer equipment.

Policies and Procedures

We conducted tests of purchase orders to detect duplicate payments, payments that were unusual or unique, payments to State and Foundation employees as vendors, payments to employees dually employed by both the State and Foundation, and payments to employees after termination. We found no exceptions. However, the Foundation did not have written policies and procedures for the following areas:

- Federal Letter of Credits;
- Federal Funds Draw Down;
- Federal Reporting Requirements;
- Billings, Accounts Receivable and Collection;
- Past Due Accounts Receivable;
- Grant Award Closeout; and
- Accounts Payable and Invoice Payment.

Policies and procedures provide direction to those assigned to carry out functions and are an integral part of an internal control system.

In addition, we tested controls over travel expenses by selecting the top 25 travelers at the Foundation and reviewed their travel expenses. We found no exceptions. However, the Foundation has seven corporate credit cards for travel expenses and office supplies, with credit limits ranging from \$2,000 to \$17,000. The Foundation needs to develop policies and procedures relating to the issuance and use of credit cards for business purposes to reduce risk and detect improper use.

Recommendation

7. Foundation management should develop and implement policies and procedures for revenue and procurement operations detailed in our report, including the issuance and use of corporate credit cards.

AUDIT SCOPE AND METHODOLOGY

We conducted our audit in accordance with generally accepted government auditing standards. Our audit assessed whether the Foundation's Board is fulfilling its legal and fiduciary obligations, and whether the Foundation has instituted appropriate internal controls over revenue and procurement operations for the period April 1, 2002 through August 31, 2005. To accomplish our audit objectives, we met with officials from the Foundation, the Department of Mental Hygiene's agencies - Office of Mental Health, Office of Mental Retardation and Developmental Disabilities, and Office of Alcoholism and Substance Abuse Services. We also visited the three research institutes. In addition, we reviewed the Foundation's policy and procedures manual to understand its internal controls over revenue and procurement operations.

For the period May 2002 through March 2005, the Foundation processed more than 31,000 purchase orders with a value of over \$68 million. From these transactions, we judgmentally selected a sample of 50 purchase orders of various dollar amounts for purchases such as office supplies, consulting services, food for research subjects and personal computers with a total value of more than \$2 million to test the controls in place. For these same 31,000 purchase orders, we conducted data analysis that included tests for duplicate payments, payments that were

unusual or unique, payments to State or Foundation employees as vendors, payments to employees dually employed by both the State and Foundation, and payments to employees after termination. In addition, the Foundation incurred \$3.2 million in travel expenses for more than 1,700 employees from which we tested the top 25 travelers who incurred more than \$467,000 in travel expenses.

We also tested the inventory controls at the three research institutes by judgmentally selecting a sample of 82 items with a value of over \$1.2 million from a population of more than 9,900 inventoried items with a value of more than \$22 million as of August 2005. We judgmentally selected a sample which included items particularly vulnerable for abuse, theft or personal use such as laptop computers, printers, digital cameras and video recorders. In addition, to determine whether any Foundation officials or Board members may have benefited inappropriately as a result of the procurement transactions, we used special auditing software to analyze information maintained on various databases.

In addition to being the State Auditor, the Comptroller performs certain other constitutionally and statutorily mandated duties as the chief fiscal officer of New York State, several of which are performed by the Division of State Services. These include operating the State's accounting system; preparing the State's financial statements; and approving State contracts, refunds, and other payments. In addition, the Comptroller appoints members to certain boards, commissions and public authorities, some of whom have minority voting rights. These duties may be considered management functions for purposes of evaluating

organizational independence under generally accepted government auditing standards. In our opinion, these management functions do not affect our ability to conduct independent audits of program performance.

AUTHORITY

The audit was performed pursuant to the State Comptroller's authority as set forth in Article V, Section 1 of the State Constitution and Article II, Section 8 of the State Finance Law.

REPORTING REQUIREMENTS

We provided a draft copy of this report to Foundation officials for their review and comment. Foundation officials generally agreed with our recommendations and indicated actions planned and taken to implement them. A complete copy of the Foundation's response is included as Appendix A.

Within 90 days of the final release of this report, as required by Section 170 of the Executive Law, the Managing Director of the Research Foundation for Mental Hygiene, Inc. shall report to the Governor, the State Comptroller, and the leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and where recommendations were not implemented, the reasons therefor.

CONTRIBUTORS TO THE REPORT

Major contributors to this report include William Challice, David R. Hancox, Sheila Emminger, Ronald Pisani, Bob Mainello, Erika Akers, Craig Coutant, Jon Deeb, Thierry Demoly, Résa Ostrander and Paul Bachman.

APPENDIX A - AUDITEE RESPONSE

RESEARCH FOUNDATION FOR MENTAL HYGIENE, INC.

150 Broadway – Suite 301, Menands NY 12204

Tel: (518) 474-5661 Fax: (518) 474-6995

Robert E. Burke, CPA
Managing Director

June 14, 2006

Mr. William Challice
Audit Director
Office of the State Comptroller
Division of State Services
State Audit Bureau
123 William Street – 21st Floor
New York, NY 10038

RE: Report 2005-S-7

Dear Mr. Challice,

Thank you for the opportunity to respond to the recommendations in your Draft Audit Report 2005-S-7. We were extremely pleased with your conclusions that the Foundation's Board is fulfilling its legal and fiduciary obligations and the Foundation's internal controls over revenue and procurement are functioning as intended.

Attached you will find the Foundation's reply to the recommendations noted in the Audit Report.

Thank you for the opportunity to respond to the report. Should you have any questions or require additional information, please feel free to call me.

Sincerely,



Robert E. Burke
Managing Director

- C. RFMH Audit Committee
Susan Delano, RFMH Deputy Managing Director



Recommendations:

1. The Foundation's Board should revise its By-Laws to improve the number of members who are independent and to provide for a code of ethics.
2. The Foundation's audit committee members should not be the same members serving on the finance committee.
3. The Foundation should improve attendance at quarterly Board meetings.

Response

- 1) The Board of Directors continuously reviews the governance structure and membership make-up of the Corporation as evidenced by significant changes to the By-Laws in January 2005. Independent and ethical behavior by Board members, officers and employees is of paramount importance to the Corporation and we will continue to keep these traits in the forefront of our operations as they have been the foundation for our success for the past 54 years. While we believe our current Board of Directors has sufficient independence to carry out their fiduciary duties to the Corporation, we appreciate your recommendation. The Corporation's Governance Committee has begun a review of how we might attract additional independent members to serve. We are also in the process of modifying the By-Laws to include a code of conduct and ethics.
- 2) The Foundation's Governance Committee is currently reviewing the structure of the Finance and Audit Committees to address the question of independence of these two committees.
- 3) While we continually strive to improve the attendance at each meeting, we believe it is important to stress that the Foundation has a vibrant and active Board with an excellent record of attendance and active participation at the 4 meetings held each year. In the past 10 years the Board has met 40 times and has always had a quorum. The Board has recently stepped up its efforts to encourage any Board member who cannot attend a meeting in person to attend via teleconference. We will continue to strive to improve attendance.

Recommendations:

4. The Foundation's administrative office at the Institute of Basic Research should ensure compliance with procedures for verifying whether purchases for goods or services are authorized and meet the grant's guidelines.

Response

- 4) We concur with the recommendations and the Institute has implemented the signature authorization procedures that are used at other Foundation locations. When purchases are made, the Institute's Grants office and the Foundation's

Central Office review the purchase to ensure it is reasonable, allowable and allocable to the grant it is being charged against. We will reinforce to the Institute Grants office the necessity of completing this review prior to authorizing purchases or payments.

Recommendations:

5. The Foundation should conduct independent physical inventories of equipment and durable supply inventories.
6. Foundation Investigators should notify the Foundation's administrative offices at the institutes when they move, lend or transfer equipment.

Response

- 5) & 6) We concur with these recommendations and will formulate procedures requiring all future inventories be verified by someone other than the person responsible for asset custody. We will also reinforce to all persons in possession of Foundation equipment that, in order to comply with Foundation policy, they must notify the inventory department when equipment changes location.

Recommendations:

7. Foundation Management should develop and implement policies and procedures for revenue and procurement operations detailed in our report, including the issuance and use of corporate credit cards.

Response

- 7) In 2004, the Foundation completed an initiative to update the Corporate Policy Manual. We are currently in the process of updating existing policies and procedures and are actively working on the remaining areas identified in the audit report.