



October 31, 2006

James E. Tilton, Secretary  
California Department of Corrections and Rehabilitation  
1515 S Street, Room 502 South  
Sacramento, California 95814

Dear Secretary Tilton:

The enclosed report presents the results of the Office of the Inspector General's special review into concerns communicated by the office of Senator Jackie Speier related to the Department of Corrections and Rehabilitation's substance abuse treatment programs.

The special review revealed that the department overpaid three substance abuse treatment contractors nearly \$5 million over a four-year period. The overpayments were not detected by the department because it failed to enforce contract terms requiring contractors to reconcile their revenues with their actual costs. One of the contractors also did not follow normal accounting rules and overstated its expenses by more than \$250,000 by expensing the entire value of 22 automobiles purchased with state funds.

The review also revealed that the department has violated the California Constitution and state policy by allowing contractors to retain ownership of potentially millions of dollars of equipment that is purchased with state funds but has a unit cost of less than \$5,000. Finally, the review disclosed that the department may have failed to hold a substance abuse treatment contractor accountable for mishandling confidential inmate information.

The report presents 12 recommendations to address deficiencies identified in the course of the review. The department's response appears as an attachment to the report.


Thank you for the courtesy and cooperation extended to my staff during this special review.

Sincerely,

  
MATTHEW L. CATE  
Inspector General

cc: Kingston "Bud" Prunty, Undersecretary, California Department of Corrections and Rehabilitation  
Marisela Montes, Chief Deputy Secretary, Adult Programs, California Department of Corrections and Rehabilitation  
Kim Holt, External Audits Coordinator, California Department of Corrections and Rehabilitation

Enclosures

  
Arnold Schwarzenegger, Governor

**OFFICE OF THE INSPECTOR GENERAL**

**MATTHEW L. CATE, INSPECTOR GENERAL**



**SPECIAL REVIEW INTO CONCERNS RELATED TO  
SUBSTANCE ABUSE TREATMENT CONTRACTORS**

**OCTOBER 2006**

**STATE OF CALIFORNIA**

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## EXECUTIVE SUMMARY

This report presents the results of a special review conducted by the Office of the Inspector General into the Department of Corrections and Rehabilitation's oversight of substance abuse treatment program service providers. The providers operate under contracts with the department's Office of Substance Abuse Programs. The review resulted from the following concerns raised about the actions of some of the providers by the office of Senator Jackie Speier:

- Mental Health Systems, Inc. may have inappropriately obtained and accounted for vehicle purchases related to its Region IV substance abuse services coordination agency contract.
- Phoenix Houses of California, Inc. may have improperly disposed of equipment when its contract for providing in-prison substance abuse treatment services at the California Substance Abuse Treatment Facility and State Prison at Corcoran expired on June 30, 2006.
- Phoenix Houses of California, Inc. may have improperly disposed of confidential records and information when its contract for providing in-prison substance abuse treatment services at the California Substance Abuse Treatment Facility and State Prison at Corcoran expired on June 30, 2006.

The Office of the Inspector General performed the review between July 17, 2006 and October 16, 2006 under the authority of California Penal Code section 6126, which assigns the Inspector General responsibility for oversight of the Department of Corrections and Rehabilitation.

The department's Office of Substance Abuse Programs contracts with organizations that provide in-prison substance abuse treatment for inmates in custody and community-based treatment services for inmates who have been paroled. The in-prison providers operate 38 therapeutic community programs at 22 institutions statewide. The programs offer inmates four to thirty-six months of programming, and in fiscal year 2006-07 had a total bed capacity of nearly 9,200. In each of the state's four parole regions, the Office of Substance Abuse Programs also contracts with organizations that serve as substance abuse services coordination agencies to help inmates transition from in-prison programs to community-based services. At present, the Office of Substance Abuse Programs budgets \$143 million annually to operate and oversee the drug treatment programs, with about \$37 million of that amount allocated to in-prison programs, about \$60 million allocated to substance abuse services coordination agencies, and the remaining spent on other drug treatment programs and administration.

The Office of the Inspector General found from the review that the department's oversight of the substance abuse treatment contractors is lacking. The review determined that the department overpaid three drug treatment service coordinators—Mental Health Systems, Inc., Walden House, Inc., and WestCare—nearly \$5 million from fiscal year 2000-01 through

2003-04 because it did not require the contractors to reconcile revenues to actual costs as required under the contracts. The department should have compensated the providers for the lesser of the actual costs of providing the services or an amount determined by using rates established in the contracts. Instead, because the department did not enforce the reconciliation requirement provided in the contracts, it paid the contractors amounts that exceeded the actual costs of providing the services.

The review also determined that Mental Health Systems, Inc. overstated its expenses for providing services by more than \$250,000 from fiscal year 2000-01 through 2003-04 by expensing the entire value of 22 automobiles purchased with state funds during that period. The contractor instead should have depreciated the costs over the useful life of the vehicles—generally established as five years.

In both cases, it appears that the time available for the department to recover the lost amounts will expire at the end of 2006 or shortly thereafter, underscoring the need for the department to act quickly to protect the state's interests.

The Office of the Inspector General found in addition that the department has improperly allowed contractors to retain ownership of potentially millions of dollars of equipment purchased with state funds. The problem results from a line item budget guide developed by the department that allows contractors to retain ownership of equipment purchased with state monies if the equipment has a unit cost of less than \$5,000. That provision is inconsistent with the State Administrative Manual, which provides that any equipment purchased or built with state funds vests in the state, and also violates the California Constitution, which prohibits the gift of public money or anything of value to any individual for a private purpose.

The Office of the Inspector General determined that under the provision in the department's line item budget guide, a contractor that had operated an in-prison substance abuse treatment program at the Substance Abuse and Treatment Facility and State Prison at Corcoran, whose contract was not renewed after June 30, 2006, took numerous computers, television sets, and fax machines when it vacated the program. The contractor, Phoenix Houses of California, Inc. kept the equipment though it had been purchased with state funds.

The effect of the improper provision in the line item budget guide extends far beyond that one example, however. The current budget guide has been in effect since October 2002, and the department applies its provisions to all of its cost reimbursement contracts. In fiscal year 2005-06 alone, the department processed contracts totaling more than \$2.6 billion, meaning that the loss to the state could amount to millions of dollars.

In addition to the findings of monetary loss resulting from deficiencies in the department's oversight of substance abuse treatment service contractors, the special review also revealed that the department mishandled an investigation of the improper disposal of confidential inmate information. The department determined that confidential inmate records from a substance abuse treatment program at the California Substance Abuse Treatment Facility

and State Prison at Corcoran, including names, identification numbers, ethnicities, birthdates, release dates, and other information, was placed in the dumpster of a nearby private business. However, the investigative services unit at the institution failed to adequately investigate the incident and the department took no further action in the matter despite the potential violation of federal and state law and even though the department's contracts with the substance abuse treatment providers include a specific provision requiring contractors to protect confidential information against unauthorized use or disclosure.

The Office of the Inspector has issued 12 recommendations as a result of this special review.

## INTRODUCTION

This report presents the results of a special review conducted by the Office of the Inspector General into questions raised by the office of Senator Jackie Speier concerning the Department of Corrections and Rehabilitation's substance abuse programs. The review was conducted pursuant to the Office of the Inspector General's responsibility under California Penal Code section 6126 for oversight of the California Department of Corrections and Rehabilitation and its subordinate entities. The review was performed between July 17, 2006 and October 16, 2006.

## BACKGROUND

The California Department of Corrections and Rehabilitation established the Office of Substance Abuse Programs in 1989 in response to a dramatic increase in the number of offenders committed to the state's prisons and returning to custody because of drug-related offenses. The Office of Substance Abuse Programs is responsible for designing, developing, and implementing effective alcohol and drug treatment programs for inmates and parolees. The office contracts with various organizations that provide both in-prison treatment services for inmates still in custody and community-based treatment services for inmates who have been paroled. At present, the Office of Substance Abuse Programs budgets \$143 million annually to operate and oversee the drug treatment programs.

In-prison substance abuse treatment providers operate 38 programs at 22 institutions under contracts with the department. The in-prison programs had a total bed capacity of nearly 9,200 inmates in fiscal year 2006-07 and account for about \$37 million of the \$143 million budget. Inmates enrolled in the in-prison substance abuse treatment program participate in four to thirty-six months of programming in "therapeutic communities." Nationwide, more than 250 in-prison drug treatment programs using the therapeutic community model have been established in 40 states.

Although participation in community-based substance abuse treatment programs is voluntary, the department strongly encourages the inmates who have participated in the in-prison substance abuse treatment program to continue treatment in a community-based program after they parole. Community-based organizations provide a variety of substance abuse treatment programs for parolees, including residential treatment, non-residential treatment, sober living environments, and self-help groups. The community-based organizations operate under contracts with substance abuse services coordination agencies, which act on the behalf of the department.

The department has contracted with organizations to serve as substance abuse services coordination agencies in each of the state's four parole regions. Between 1998 and 2003 three organizations—Mental Health Systems, Inc., Walden House, Inc., and WestCare—provided these services, with Walden House Inc. serving two of the four parole regions. The substance abuse services coordination agencies assist inmates with their transition from the in-prison component of the substance abuse treatment program to the community-based program and coordinate with each in-prison substance abuse treatment provider to ensure a

continuum of care and the integration of community services for inmates being paroled. Each substance abuse services coordination agency refers and places parolees who have completed the in-prison substance abuse treatment program into appropriate community-based programs and monitors and reports to the Office of Substance Abuse Programs on the parolees' participation and progress in the program. The substance abuse services coordination agencies account for approximately \$60 million of the \$143 million annual budget. The department budgets approximately \$46 million for other drug treatment programs and administration.

## **OBJECTIVES, SCOPE, AND METHODOLOGY**

The objective of this special review was to respond to concerns communicated to the Office of the Inspector General by the office of Senator Speier about the activities of two entities operating under contract with the department's Office of Substance Abuse Programs. The first concern was that Mental Health Systems, Inc., a nonprofit organization based in San Diego, might have inappropriately purchased automobiles with state funds. Other concerns related to the disposal of equipment and confidential records by Phoenix Houses of California, Inc., which operated an in-prison substance abuse program for the department. Those concerns centered on actions taken by Phoenix Houses of California, Inc. at the time its contract with the department expired on June 30, 2006.

In the review, the Office of the Inspector General set out to answer the following concerns raised by Senator Speier's office:

- Mental Health Systems, Inc. may have inappropriately obtained and accounted for vehicle purchases related to its Region IV substance abuse services coordination agency contract.
- Phoenix Houses of California, Inc. may have improperly disposed of equipment when its contract for providing in-prison substance abuse treatment services at the California Substance Abuse Treatment Facility and State Prison at Corcoran expired on June 30, 2006.
- Phoenix Houses of California, Inc. may have improperly disposed of confidential records and information when its contract for providing in-prison substance abuse treatment services at the California Substance Abuse Treatment Facility and State Prison at Corcoran expired on June 30, 2006.

The Office of the Inspector General expanded its review beyond these three concerns based on issues it identified as it completed its work.

In conducting the fieldwork for this special review, the Office of the Inspector General performed the following procedures:

- Interviewed staff at the department's Office of Substance Abuse Programs to gain an understanding of its oversight over contractors.



- Reviewed relevant contracts, applicable laws, policies, procedures, and other criteria related to the functions carried out by the two identified contractors, as well as other contractors providing similar services.
- Interviewed appropriate staff at Mental Health Systems, Inc. and reviewed associated financial records related to the organization's purchase of automobiles.
- Interviewed appropriate staff of contractors that provided services similar to Mental Health Systems, Inc. to determine whether Mental Health Systems, Inc.'s methods of accounting for automobile expenses were employed by others.
- Interviewed key department and contractor staff at the California Substance Abuse Treatment Facility and State Prison at Corcoran and reviewed relevant documents to determine the appropriateness of the actions of Phoenix Houses of California, Inc. in disposing of equipment and confidential program information when its contract for providing in-prison substance abuse treatment services at the California Substance Abuse Treatment Facility and State Prison at Corcoran expired on June 30, 2006.
- Analyzed the information gathered through the above procedures and formulated conclusions.

## FINDING 1

**The Office of the Inspector General found that the department overpaid three contractors nearly \$5 million from fiscal year 2000-01 through 2003-04 because it did not require the contractors to reconcile revenues to their actual costs, as required under the contracts.**

The California Department of Corrections and Rehabilitation failed to require the three substance abuse services coordination agency contractors—Mental Health Systems, Inc., Walden House, Inc., and WestCare—to reconcile revenues with actual costs as specified in their contracts. As a result, the department overpaid the contractors nearly \$5 million over a four-year period. The contracts provided for the three companies, which act as the substance abuse services coordination agencies, to receive compensation using rates established in the contracts for the various services they provided—coordinating the continuance of substance abuse treatment for inmates who are being paroled into the community. The contracts also required the service coordinators to periodically reconcile revenues received with actual costs of providing the services, and if revenues exceeded actual costs, for the difference to be refunded to the department. Put another way, the contracts called for the department to compensate the service coordinators for the *lesser* of the contractors' actual costs of providing services or an amount determined by using the rates established in the contract. Because the contracts in question spanned the period December 1, 1998 to December 31, 2003, and because the contracts may be subject to review for only three years after final payment of the contract, the time remaining for the department to recover the nearly \$5 million in overpayments may be short.

***The department did not require the contractors to perform reconciliations.*** Because the department did not require the service coordinators to perform reconciliations between revenues and actual costs to determine the method that resulted in lower costs, the department paid the contractors amounts that exceeded the actual costs of providing the services. As shown in Table 1, the service coordinators' revenues under the contracts exceeded their actual costs in each of fiscal years 2000-01 through 2003-04. Totaled together, the overpayments amounted to nearly \$5 million.

According to the chief financial officer of Mental Health Systems, the company did not perform the reconciliation because it was the understanding of his staff from reading the contract and from discussions with the department's Office of Substance Abuse Programs that the reconciliation was not required. A review of the contract, however, shows that such reconciliation was clearly required. As discussed later in this report, Mental Health Systems believed the contract was a "fee-for-service" type contract—which bases revenue on the completion of services, compensated at established rates—rather than a cost reimbursement type contract—which bases compensation on the actual costs of providing services.

In fact, the contracts under which Mental Health Systems and the other service coordinators operated during this period required contractors to follow a hybrid approach to determine compensation. The contracts provided that the service coordinators be initially compensated

using agreed-upon rates for the services they provided—which is consistent with a fee-for-service contract.

However, the contracts also called for the service coordinators to periodically reconcile contract revenue received—using the established rates—to the actual costs of providing the services. If the actual costs were less, the difference was to be repaid by the contractor. Under this hybrid approach, the service coordinators were to be paid the lower of either the established rates or the actual costs of providing services.

***The contracts required reconciliations.*** For these contracts, the department chose to compensate the service coordinators through separate contractors that operated in-prison substance abuse treatment programs at various prisons throughout the state. Under that arrangement, the department provided funding to the in-prison treatment providers, who then subcontracted with the service coordinators to provide substance abuse coordination services to inmates who paroled to the service coordinators’ designated geographical regions. In its contracts with the in-prison treatment providers, the department clearly required providers to ensure that the service coordinators performed periodic reconciliations of revenues with actual costs of providing services. Specifically, the contracts provided as follows:

*The Contractor shall have the fiscal capacity to assure that [substance abuse services coordination agency] reimbursements can be made ... The fiscal system shall allow an interim reimbursement based on units of service provided, so long as final reimbursement is based on the lower of actual cost or the established rate per unit of service. The [substance abuse services coordination agency] shall provide for a database on participant services which may be used for this purpose. The database shall*

FISCAL YEAR	REVENUES	EXPENSES	EXCESS REVENUE
<b>2000-01</b>			
<b>Mental Health Systems</b>	\$ 1,425,479	\$1,407,867	<b>\$ 17,612</b>
<b>Walden House<sup>5</sup></b>	11,792,041	11,561,808	<b>230,233</b>
<b>WestCare</b>	<sup>1</sup> 985,467	<sup>1</sup> 535,964	<sup>1</sup> <b>449,503</b>
<b>2001-02</b>			
<b>Mental Health Systems</b>	1,837,829	1,743,840	<b>93,989</b>
<b>Walden House<sup>5</sup></b>	15,102,112	14,600,386	<b>501,726</b>
<b>WestCare</b>	<sup>2</sup> 10,375,361	<sup>2</sup> 9,269,535	<sup>2</sup> <b>1,105,826</b>
<b>2002-03</b>			
<b>Mental Health Systems</b>	2,919,343	2,581,275	<b>338,068</b>
<b>Walden House<sup>5</sup></b>	13,354,951	12,649,924	<b>705,027</b>
<b>WestCare</b>	<sup>3</sup> 9,983,456	<sup>3</sup> 8,922,713	<sup>3</sup> <b>1,060,743</b>
<b>2003-04</b>			
<b>Mental Health Systems</b>	1,612,981	1,531,443	<b>81,538</b>
<b>Walden House<sup>5</sup></b>	6,148,377	5,741,495	<b>406,882</b>
<b>WestCare</b>	<sup>4</sup>	<sup>4</sup>	<sup>4</sup>
<b>Totals</b>	<b>\$75,537,397</b>	<b>\$70,546,250</b>	<b>\$4,991,147</b>
<sup>1</sup> WestCare could not provide complete accounting records for fiscal year 2000-01. Shown here is information for the period January through November 2000. <sup>2,3</sup> WestCare’s fiscal year spans January through December. Shown here is information for the periods: <sup>2</sup> January through December 2002. <sup>3</sup> January through December 2003. <sup>4</sup> Information from July 2003 through December 2003 is included in <sup>3</sup> above. <sup>5</sup> Walden House provided services in two separate parole regions.  Source: Contractors’ unaudited financial records.			

*contain at least the following data elements: ... the costs for the services, pending settlement to the lower of price per unit of service or actual cost of services.*

The contracts further provided:

*The agreements between the in-prison Contractors and the [substance abuse services coordination agencies] shall contain [among others] a description of the system for reimbursement of [substance abuse services coordination agencies] for services provided to or purchased for participants, including how reimbursement will be reconciled to the lower of fixed price or actual cost.*

The Office of the Inspector General found in addition that contracts Mental Health Systems made with the various in-prison treatment providers to receive substance abuse services coordination agency funding included the requirement that Mental Health Systems reconcile revenues with its actual costs and refund the difference. Indeed, five of these contracts were between Mental Health Systems, in its role as an in-prison treatment provider at four different prisons, and itself, as a substance abuse services coordination agency.

***Because the reconciliations were not done, the department overpaid the contractors.***

It is clear therefore that the service coordinators received excessive revenue in fiscal years 2000-01 through 2003-04, as shown in Table 1. In addition, Mental Health Systems overstated its expenses during this time period by more than \$250,000, an issue discussed in more detail in Finding 2 of this report. The effect of the overstated expenses, with the excessive revenues discussed above, brings the amount the department inappropriately paid Mental Health Systems to more than \$780,000.

The department changed its method of contracting with service coordinators in January 2004 to eliminate the reconciliation requirement. The department structured each of the service coordinator contracts that went into effect on January 1, 2004, so that the department made payments directly to the service coordinators rather than paying them through the in-prison treatment providers. The department also revised the method of compensating service coordinators to solely cost-reimbursement. Therefore, the reconciliation requirement that existed in the previous contract under the hybrid approach to compensation no longer exists and the possibility of future overpayments resulting from the reconciliation problem has been eliminated.

***Time may be short for the department to recover past overpayments.*** It appears that the period available for the department to recover the past overpayments may be rapidly coming to a close. Under state law, the department has until December 31, 2007 to file legal claims against the contractors, but the contractors may not be required to retain contract-related records that long. The department's contracts with the substance abuse services coordination agencies do not clearly specify how long the contractors must retain records related to operations under the contract, but do contain a provision that subjects the agencies to review by the California State Auditor for three years after final payment under the contract. Because the initial contracts ended on December 31, 2003, with final payments probably occurring sometime soon afterward, the three-year period will end on December 31, 2006 or shortly thereafter. Also, the department's line item budget guide—which provides guidance for contractors to follow in determining allowable costs under cost

reimbursement contracts with the department—provides that audits and reviews may be conducted at any time during the performance of the contract or during the three years following the end of the contracting period. Although the department did not incorporate the line item budget guide into the initial service coordinator contracts, it has incorporated the guide into the current service coordinator contracts and other substance abuse contracts. The budget guide may therefore provide guidance in determining the period during which the service coordinators are subject to review and audit. Under the provisions of the budget guide, the period for audit and review of the initial service coordinator contracts would end on December 31, 2006, meaning the department will have to respond quickly if it is to protect the state's interest in this matter.

Finally, the department's contracts with the service coordinators include a dispute clause in which both parties agree to resolve claims or disputes arising under the contracts pursuant to the provisions contained in the department's operations manual. The operations manual provides for informal and formal appeals that contractors can submit to department management in the event of a claim or dispute. It also acknowledges either parties' right to pursue legal remedies through arbitration or litigation. In the event of litigation, section 337 of the Code of Civil Procedure establishes a statute of limitations of four years from the date of the last payment made under the contract. The statute of limitations for legal action under the service coordinator contracts would lapse on December 31, 2007, or shortly thereafter.

#### **RECOMMENDATION**

**The Office of the Inspector General recommends that the department require the substance abuse services coordination agencies to reconcile revenues received during the contracts covering the period December 1, 1998 to December 31, 2003 with the actual costs of providing the services and refund any excess revenue received during that period.**

#### **FINDING 2**

**The Office of the Inspector General found that Mental Health Systems, Inc. inappropriately expensed the entire value of 22 automobiles purchased with state funds from fiscal year 2000-01 through 2003-04, overstating its expenses by more than \$250,000.**

Mental Health Systems Inc., which coordinates the continuance of substance abuse treatment for inmates who are being paroled into the community, overstated its expenses by more than \$250,000 over a four-year period when it charged the entire value of the automobiles at the time of purchase instead of depreciating the costs over the useful life of the vehicles.

Mental Health Systems has functioned as a substance abuse services coordination agency for the California Department of Corrections and Rehabilitation since December 1, 1998. In that role, Mental Health Systems contracts with community-based substance abuse treatment

providers to provide services to paroling inmates, and then coordinates with in-prison treatment providers to facilitate the transition of the inmate from the in-prison substance abuse treatment programs to community-based programs. The initial contract between the department and Mental Health Systems spanned December 1, 1998 to December 31, 2003. Mental Health Systems received a new contract to continue in this role beginning January 1, 2004 and continuing through December 31, 2006.

***Mental Health Systems had a clear need for transportation.*** As part of its responsibilities under the contracts, Mental Health Systems provides transportation to paroling inmates and makes visits to monitor the parolees’ progress in the community-based substance abuse treatment programs. Accordingly, Mental Health Systems had a need to acquire a means of transportation for its staff to carry out these responsibilities. Mental Health Systems chose to purchase automobiles to meet its need for transportation under the contract. During fiscal years 2000-01 through 2003-04—the span of its initial substance abuse services coordination agency contract—Mental Health Systems purchased 22 vehicles and recorded the related costs as expenses in its accounting system under its substance abuse services coordination agency operation.

***Mental Health Systems recorded the costs improperly.*** As shown in Table 2, however, rather than depreciating the costs of the automobiles over the useful life of the vehicles,

TABLE 2		
AUTOMOBILES PURCHASED BY MENTAL HEALTH SYSTEMS		
FISCAL YEAR	NUMBER OF AUTOMOBILES PURCHASED	TOTAL AMOUNT EXPENSED
2000-01	1	\$24,859
2001-02	6	82,267
2002-03	9	143,489
2003-04	6	80,215
<b>Totals</b>	<b>22</b>	<b>\$330,830</b>

Mental Health Systems expensed the entire cost of the automobiles at the time of purchase. Under the contract, Mental Health Systems was required to adhere to generally accepted accounting principles as outlined by the American Institute of Certified Public Accountants. A generally accepted accounting principle called “matching” requires each expense item related to revenue earned to be recorded in the same accounting period as the revenue it helped to earn. If this is not done, the financial statements will not

measure the results of operations fairly. Because the automobiles were to be used by Mental Health Systems to deliver services in periods beyond the period in which they were purchased, to appropriately account for the vehicles, Mental Health Systems should have capitalized and depreciated the automobiles over their useful lives.

***Mental Health Systems mistakenly believed the contract was “fee-for-service.”***

According to the chief financial officer of Mental Health Systems, the company believed that the original contract was a fee-for-service contract, and as such, there were no limits on how it could use the earned funds once Mental Health Systems provided its services. Accordingly, Mental Health Systems expensed the entire cost of the automobiles at the time of purchase. The chief financial officer told the Office of the Inspector General that this conclusion was based on the company’s understanding of the contract as well as discussions

between its staff and representatives of the department's Office of Substance Abuse Programs.

As discussed in Finding 1, however, the contract under which Mental Health Systems operated during this period requires it to follow a hybrid approach to determine its compensation. The contract provides that Mental Health Systems can be compensated using agreed-upon rates for the services that Mental Health Systems provided—which is consistent with a fee-for-service contract—but the contract also called for Mental Health Systems to periodically reconcile contract revenue received using established rates to its actual costs of providing the services. If actual costs were less, the difference was to be repaid by Mental Health Systems to the department. Under this hybrid approach, Mental Health Systems was to receive the lower of the established rates or its actual costs of providing services.

To perform the reconciliation, Mental Health Systems would have needed to record costs accurately and appropriately to determine the actual costs of providing services—including transportation. Because it did not follow generally accepted accounting principles in recording the automobile purchases, Mental Health Systems' costs were not accurately stated, but instead were overstated.

***Mental Health Systems overstated its expenses by more than \$250,000.*** As shown in Table 3, when the amounts Mental Health Systems inappropriately recorded as expenses during the period of the initial substance abuse services coordination agency contract are reversed, and the proper amounts are applied using generally accepted accounting principles, it becomes clear that Mental Health Systems overstated its expenses by more than \$250,000.

	FISCAL YEAR				
	2000-01	2001-02	2002-03	2003-04*	TOTALS
<b>Recorded Expenses</b>	\$24,859	\$82,267	\$143,489	\$80,215	<b>\$330,830</b>
<b>Proper Depreciation **</b>	414	6,343	24,823	41,000	<b>72,580</b>
<b>Difference – Amount Expenses Overstated</b>	<b>\$24,445</b>	<b>\$75,924</b>	<b>\$118,666</b>	<b>\$39,215</b>	<b>\$258,250</b>
<p>* This period covers July 1, 2003 through December 31, 2003, which is when Mental Health Systems' initial contract terminated.</p> <p>** The Office of the Inspector General calculated depreciation using straight line depreciation over a five-year life. The five-year life is commonly used for business automobiles and appears reasonable in this case because Mental Health Systems told the Office of the Inspector General that most of the vehicles are still in use.</p>					

***Mental Health Systems' current contract does not authorize depreciation.*** Using generally accepted accounting principles, Mental Health Systems would be able to continue depreciating its automobile expenses under its current substance abuse services coordination agency contract, which began on January 1, 2004, because it continues to use most of the

vehicles it purchased. Under the terms of that contract, however, Mental Health Systems must obtain advance authorization from the department to charge costs, such as depreciation of automobiles. Mental Health Systems did not include such a request in that contract. According to the chief operating officer of Mental Health Systems, it would have included a request for depreciation of its automobiles if it had been aware at that time that it had inappropriately expensed its automobiles. Nonetheless, because Mental Health Systems did not request authorization for such costs in its current contract, it is not allowed to charge them to this contract, which spans January 1, 2004 through December 31, 2006.

As discussed in Finding 1 of this report, Mental Health Systems based its billings for its substance abuse services coordination agency activities on established rates but did not later reconcile its actual costs to revenue it received. Since Mental Health Systems did not perform the reconciliation, its actual costs had no impact on the amount of revenue it received. Therefore, Mental Health Systems' improper recording of the expenses related to its purchases of automobiles did not result in the company requesting and receiving excessive program revenues. However, when the department requires Mental Health Systems to reconcile its actual costs of providing services with its revenue received using established rates, as discussed in Finding 1, the department should ensure that Mental Health Systems adjusts its actual costs of providing services during those periods to accurately reflect the cost of the automobiles, as described in Table 3 above.

#### **RECOMMENDATIONS**

**The Office of the Inspector General recommends that the department require Mental Health Systems to restate its expenses to record the costs of its purchases of automobiles in accordance with generally accepted accounting principles.**

**The Office of the Inspector General also recommends that the department ensure that Mental Health Systems uses its adjusted actual costs of providing services during these periods when reconciling its revenues to actual costs.**

#### **FINDING 3**

**The Office of the Inspector General found that the department violated state law and policy by allowing contractors to retain ownership of potentially millions of dollars of property purchased with state funds.**

The California Department of Corrections and Rehabilitation has developed a line item budget guide for contractors to follow in determining allowable costs under cost reimbursement contracts with the department. In violation of state law and policy, however, the department included a provision in the budget guide that allows contractors to retain ownership of equipment purchased with state funds if the equipment has a unit cost of less than \$5,000. As a result, the department has given away state equipment costing potentially millions of dollars.



The department developed the budget guide to assist contractors in following the department's requirements related to cost reimbursement contracts. The budget guide is incorporated into the department's cost reimbursement contracts by reference and provides detailed guidance to contractors in determining what costs are allowable to be reimbursed under the contract. The budget guide includes information related to costs for items such as personnel, staff benefits, subcontractors, and operations.

***The budget guide allows contractors to keep certain equipment items.*** Within the section of the budget guide that discusses operating costs, the department has included a discussion of costs related to supplies and expendable equipment. That discussion includes the following statement:

*Expendable equipment purchased will remain the property of the Contractor. Expendable equipment is defined as having a unit acquisition cost of less than \$5,000 per unit. [Emphasis in original]*

This provision allows contractors that purchase equipment costing less than \$5,000 with state funds to retain ownership of the equipment. Accordingly, a contractor that operated an in-prison substance abuse treatment program at the Substance Abuse Treatment Facility and State Prison at Corcoran—Phoenix Houses of California, Inc.—whose contract was not renewed after June 30, 2006, took numerous computers, television sets, and fax machines when it vacated the program. Since it is likely that none of the items had a unit value of \$5,000 or more, the contractor retained ownership of the equipment under the provision in the budget guide, even though the equipment was purchased with state funds.

***The budget guide provision violates state law and policy.*** The provision is contrary to the State Contracting Manual, which is incorporated into the State Administrative Manual. Specifically, section 7.29 of the State Contracting Manual provides as follows:

*When equipment is purchased or built with state funds as part of the contract [,] the contract must state that title to any equipment purchased or built with state funds will vest in the state [Emphasis added]. On termination of the contract, the state may:*

- 1. Request such equipment be returned to the state, with the costs incurred by the contractor for such return being reimbursed by the state.*
- 2. Authorize the continued use of such equipment for work to be performed under a different agreement or contract.*

In addition, the California Constitution, Section 6, Article XVI, prohibits the giving of any gift of public money or anything of any value to any individual for a private purpose. This constitutional prohibition is designed to ensure that the resources of the state are devoted to public purposes. It is therefore improper for the department to include a provision in its budget guide that allows contractors to retain ownership of equipment with a unit value of less than \$5,000.

According to a senior management auditor in the department's Office of Audits and Compliance, the department included this provision in the budget guide because the State

Administrative Manual does not require state agencies to track equipment that costs less than \$5,000. The auditor asserted that equipment costing less than \$5,000 is synonymous with supplies and therefore remains the property of the contractor, adding, “the department is not in the business of retaining used expendable equipment.”

It appears that the department mistakenly applied policies intended for state agencies to its contractors. The State Administrative Manual, section 8602, requires state agencies to capitalize equipment with a unit value of more than \$5,000. As discussed above, the State Contracting Manual clearly requires state agencies to ensure that all equipment purchased by contractors using state funds remain the property of the state.

***The department may have given away millions of dollars in equipment.*** The Office of the Inspector General reviewed the department’s accounting records and invoices submitted by substance abuse program contractors during fiscal year 2004-05 in an attempt to determine how much equipment the department has allowed contractors to retain, but found the department does not capture the information needed to determine that amount. On invoices submitted to the department, substance abuse program contractors categorize their costs according to the descriptions contained in the line item budget guide. As discussed above, the department combines supplies and expendable equipment in the same section. Accordingly, when contractors report the costs they have incurred in carrying out substance abuse treatment services, they combine the amounts expended for supplies and expendable equipment. The Office of the Inspector General was, therefore, unable to separate the value of the equipment from the value of the supplies in the line item, but the amount reported by all substance abuse program contractors for this line item in fiscal year 2004-05 was more than \$1.1 million. Considering that the department’s current budget guide has been in effect since October 2002; that the department applies the budget guide to contracts beyond the substance abuse program; and that in fiscal year 2005-06 alone, the department processed more than \$2.6 billion in contracts, the amount of equipment relinquished to contractors through this inappropriate provision of the budget guide is likely substantial.

## **RECOMMENDATIONS**

**The Office of the Inspector General recommends that the department immediately revise its budget guide and all current cost reimbursement contracts to:**

- **Ensure that ownership of all property purchased by contractors with state funds vests with the state.**
- **Require contractors to leave all equipment purchased with state funds as part of a cost reimbursement contract for use by subsequent contractors or for the department to otherwise utilize according to its needs.**

**The Office of the Inspector General also recommends that the department revise its budget guide to require future contractors to leave all unused supplies purchased with state funds as part of a cost reimbursement contract**

for use by subsequent contractors or for the department to dispose of according to its needs.

Finally, the Office of the Inspector General is referring the matter relating to the department's gift of public funds to contractors to the Office of the Attorney General for its consideration in recovering equipment the department improperly gifted to contractors. The Office of the Inspector General recommends that the department cooperate fully with the Office of the Attorney General in this matter.

#### FINDING 4

**The Office of the Inspector General found that the department may have failed to hold a contractor accountable for mishandling confidential inmate information.**

In June 2006, the department determined that confidential inmate information related to a substance abuse treatment program operated by Phoenix Houses of California, Inc. at the California Substance Abuse Treatment Facility and State Prison at Corcoran had been improperly discarded in the dumpster of a nearby business. This mishandling of confidential inmate information may have violated state and federal law. However, the investigative services unit at the California Substance Abuse Treatment Facility and State Prison at Corcoran was deficient in investigating the incident, and as a result, the department did not hold the responsible party accountable for its actions.

Phoenix Houses of California, Inc. operated an in-prison therapeutic community substance abuse program at the California Substance Abuse Treatment Facility and State Prison at Corcoran under a contract with the department's Office of Substance Abuse Programs. The contract provided for the company to be responsible for developing and providing a substance abuse treatment program to more than 700 inmates and for facilitating continuing services for inmates transitioning from the in-prison program to a community-based program after parole. The term of the contract was from January 1, 2002, through June 30, 2006. Beginning July 1, 2006 the department contracted with another contractor to continue the substance abuse treatment services at the California Substance Abuse Treatment Facility and State Prison at Corcoran. Accordingly, Phoenix Houses of California, Inc. wrapped up its program operations and vacated the premises.

***Inmate information was discarded in a dumpster of a local business.*** On June 23, 2006, the manager of a nearby business called the prison's associate warden of business services to complain that multiple items belonging to the prison had been placed inside that business's dumpster. The associate warden dispatched an employee to the business to collect the items discovered in the dumpster. The employee retrieved several boxes of paperwork belonging to Phoenix Houses of California, Inc., and it was determined that the documents related to the former contractor's operation of its in-prison substance abuse treatment program at the prison.

According to the investigation report by the prison's investigative services unit, among the items found in the dumpster were the following documents:

- An inmate roster for a facility at the prison that housed inmates participating in the substance abuse programs. The roster included inmate names, identification numbers, housing assignments, ethnicity, and birthdates.
- A report detailing the caseloads assigned to treatment counselors who had been employed by Phoenix Houses of California, Inc.
- A report showing release dates for participants in the prison's substance abuse treatment program. The report included inmate names, identification numbers, housing assignments, and inmate arrival and release dates.

***Federal and state law protects inmate information from disclosure.*** The United States Code, Title 42 section 290 (dd-2) provides as follows:

*Records of the identity, diagnosis, prognosis, or treatment of any patient which are maintained in connection with the performance of any program or activity relating to substance abuse education, prevention, training, treatment, rehabilitation, or research, which is conducted, regulated, or directly or indirectly assisted by any department or agency of the United States shall ... be confidential and be disclosed only for [authorized circumstances].*

The section also provides as follows:

*Any person who violates any provision of this section or any regulation issued pursuant to this section shall be [subject to a fine].*

State law also prohibits the release of such information. Specifically, Government Code section 11019.9 requires state departments to enact and maintain a privacy policy that, among other things, ensures that personally identifiable information is obtained only through lawful means, and provides that personal data may not be disclosed, made available, or otherwise used for purposes other than those specified, except with the consent of the subject of the data, or as authorized by law or regulation. In addition, Civil Code section 1798.24 provides that "no agency may disclose personal information in a manner that would link the information disclosed to the individual to whom it pertains." The department's contract with Phoenix Houses of California, Inc. stipulated that both of these provisions applied to Phoenix Houses of California, Inc. in its operation of the in-prison substance abuse treatment program.

Because the information the department found in the dumpster contained personal information related to inmates, including names, identification numbers, ethnicity, birthdates, and release dates, as well as information that linked the inmates to a substance abuse treatment program, its mishandling appears to have violated the federal and state laws cited above.

***The investigative services unit prematurely closed its investigation.*** The investigation conducted by the prison's investigative services unit was inadequate, thereby precluding the

department from completing the proper legal analysis needed to determine who was responsible for the improper disposal of confidential inmate information. The investigative services unit interviewed several parties, including a representative of Phoenix Houses of California, Inc., the manager of the local business where the information was found, and a representative of a mobile shredding company that Phoenix Houses of California, Inc. had hired to dispose of papers from its operations at the prison. Because all the parties denied involvement in the improper disposal of the confidential information, and because the investigative services unit was unable to identify any witnesses to the improper dumping, it concluded it could not determine who was responsible, closed its investigation, and destroyed the items retrieved from the dumpster.

As the administrator of the department's substance abuse treatment programs, the Office of Substance Abuse Programs has a responsibility to ensure that contractors adhere to the terms of the contract. To its credit, the department has included in its substance abuse treatment contracts a provision requiring contractors to protect confidential information against unauthorized use or disclosure. Therefore, when a breach of confidential information by a contractor comes to the department's attention, it has a duty to respond.

In this instance, however, the investigative services unit's response was inadequate. It failed to develop the information needed to allow the department to make appropriate factual and legal conclusions as to who was responsible for the improper dumping of the confidential inmate information, and to then hold the responsible party accountable for its actions. The department's contracts with its substance abuse treatment providers, as well as state and federal law, hold the providers responsible for the proper safeguarding of inmate information. Therefore, if the department determined through a properly completed investigation that Phoenix Houses of California, Inc. was responsible for the improper disposal of confidential information, the department could hold the company accountable for its actions.

## **RECOMMENDATIONS**

**The Office of the Inspector General recommends that the investigative services unit at the California Substance Abuse Treatment Facility and State Prison at Corcoran reconsider its decision to close its investigation related to the improper disposition of confidential inmate information. In reconsidering its decision, the investigative services unit should consider the pertinent federal, state, and contractual criteria that require Phoenix Houses of California, Inc. to ensure that confidential information is properly safeguarded.**

**The Office of the Inspector General also recommends that if the investigative services unit concludes that Phoenix Houses of California, Inc. did not properly safeguard confidential inmate information, the department should:**

- **Pursue any available legal remedies for violations of federal and state laws.**

- Officially admonish Phoenix Houses of California, Inc. for its failure to safeguard confidential inmate information so that the department can consider the actions of Phoenix Houses of California, Inc. in future contracting considerations.

In addition, the Office of Substance Abuse Programs should make certain that Phoenix Houses of California, Inc. takes corrective action to ensure that confidential inmate information it possesses as part of its current or future substance abuse treatment contracts is adequately safeguarded.

If the Office of Substance Abuse Programs determines that Phoenix Houses of California, Inc. has not taken appropriate corrective actions, and therefore cannot properly safeguard confidential inmate information, the department should cancel its substance abuse treatment contracts with Phoenix Houses of California, Inc. for cause.

**RESPONSE OF THE CALIFORNIA DEPARTMENT OF  
CORRECTIONS AND REHABILITATION**

# Memorandum

Date : October 30, 2006

To : Matthew L. Cate, Inspector General  
Office of the Inspector General  
P.O. Box 348780  
Sacramento, CA 95834-8780

Subject: **RESPONSE TO THE OFFICE OF THE INSPECTOR GENERAL'S SPECIAL REVIEW INTO CONCERNS RELATED TO SUBSTANCE ABUSE TREATMENT CONTRACTORS**

This memorandum is prepared as the California Department of Corrections and Rehabilitation's (CDCR) response to the Office of the Inspector General's (OIG) Special Review into concerns related to Substance Abuse Treatment Contractors, prompted by questions from the office of Senator Jackie Speier.

After careful review, CDCR concurs with the overall findings and intent of the recommendations and has already begun steps to remedy future contractual oversight:

- CDCR is notifying each of the Substance Abuse Services Coordinating Agencies' (SASCA) providers from the 2000-01 through 2003-04 fiscal years (FY) that they are required to reconcile revenues received under the contracts covering the period December 1, 1998 to December 31, 2003, and to repay the Department for any excess revenues. The notification to the SASCA providers is also directing them to retain their accounting records for this period until this process is complete. The contractors will have an opportunity to utilize the Department's dispute and appeal processes.
- As stated in the draft special review report, CDCR changed its method of contracting for substance abuse services in January 2004. The current SASCA contracts that expire December 31, 2006, ensure that "the possibility of future overpayments resulting from the reconciliation problem no longer exists." These safeguards have been carried over into the Request For Proposal for the new contracts, scheduled to be awarded January 1, 2007.
- CDCR is notifying Mental Health Systems (MHS) that they are required to restate expenses regarding the purchase of automobiles during FYs 2000-01 through 2003-04 in accordance with Generally Accepted Accounting Principles. The contractor will be required to repay the Department any costs that were overstated as a result of their improper recording of costs. The notification to MHS is also directing them to retain their accounting records for this period until this process is complete.
- The Line Item Budget Guide (LIBG) has been revised by incorporating the language found in Section 7.29 of the State Contracting Manual to ensure that ownership of all expendable supplies and/or equipment having a unit acquisition cost of less than \$5,000, that is purchased by contractors with State funds, will vest with the State. The revised LIBG has been shared with CDCR's headquarters' contracts staff and will be transmitted statewide.



- The equipment that was taken by Phoenix House at the close of its contract at the Substance Abuse Treatment Facility has been returned to the institution for disposition.
- The Department is taking the following steps relating to the alleged mishandling of confidential inmate information:

The Information Security Office is in the process of determining whether or not the mishandled confidential inmate information contains sufficient Personally Identifying Information to prompt notification letters for each program participant. Consultation with the State Information Security Officer and the Office of Privacy Protection will occur this week. Notification letters, if required, will be sent immediately.

On October 19, 2006, the Department sent a letter to all substance abuse treatment contractors reminding them of the legal and contractual requirements for the storage and retention of confidential files.

The Office of Internal Affairs is reviewing the allegations to determine whether or not regulatory violations occurred and if further investigation is warranted.

We would like to thank the OIG for its continued professionalism and guidance in CDCR's efforts to improve its operations. Should you have any questions or concerns, please call my office at (916) 323-6001.



JAMES E. TILTON  
Secretary  
California Department of Corrections and Rehabilitation

cc: M. Hoshino, Internal Affairs  
A. Pugnier, Information Security