Department of Rehabilitation

Audit Report of the

Business Enterprise Program
Erreca Safety Road Side Rest Area
(Location 3-817)

Date: **March 14, 2012**

Control Number: **2011A-105**

<u>DOR Audit Services Team:</u>
Rachel Lanoza, Auditor
Lori Bruno, Assistant Chief

Introduction

The Department of Rehabilitation (DOR) Audit Services has completed our audit of the January 2011 through July 2011 Monthly Operating Reports (MORs) submitted by Mr. Gary Crocker, Business Enterprises Program Vendor for the Erreca Safety Road Side Rest Area (SRRA) on highway 5 in Merced County.

The BEP provides Department consumers, who are legally blind opportunities to be trained in the operation of cafeterias, vending stands, and snack bars, with the ultimate goal of becoming independent food service professionals in California. The program was created through federal legislation, the Randolph-Sheppard Act of 1936, which was enacted to provide blind persons with remunerative employment, enlarge the economic opportunities of the blind, and stimulate the blind to greater efforts in striving to become self-supporting.

BEP Vendors operate their own facility and retain the profits from the facility they manage, excluding a percentage (set-aside fee) prescribed by law. This fee is placed in the Vending Facility Trust Fund, is matched with federal funds, and is used to establish new facilities, refurbish/maintain established facilities, and pay health and dental insurance for active vendors.

State regulations require each BEP Vendor to submit a MOR to DOR by the 25th day of the following month. The MOR is a report of operations as well as the basis of calculating set-aside fees, workers' compensation and liability insurance. BEP Vendors are required to remit these fees each month with their MORs. As set-aside fees are the primary source of income for the Vending Facility Trust Fund, inaccurate and unsupported MORs could result in an underpayment of fees.

DOR also uses information reported on the MOR to assist BEP Vendors in making decisions on improving their locations, as a source for required Federal and State reports, and for the establishment of fees.

Background

BEP Vendor Gary Crocker began operating the Erreca SRRA in February 2001. Initially, only the North Bound location was operational; in September 2003, the South Bound location opened. This location currently has 20 vending machines with ten located on each of his north and south bound sides of Highway 5. He has a kiosk area for storage at each locations and also has a warehouse where he stores his vending machine product in Fresno CA.

Audit Scope/Procedures

We conducted our audit in accordance with Government Auditing Standards for fiscal compliance as defined by the Government Accountability Office, except Standard 3.52 requiring an external peer review. Our audit included examining evidence in support of expenses reported on the January and July 2011 MORs to obtain reasonable assurance that the expenses reported were compliant with the Vendor's Monthly Operating Report Instructions (MOR Instructions), applicable Federal and State regulations, and were supported by appropriate records. Our audit also included a limited review of the internal controls through use of questionnaires and interviews with the BEP Vendor. Audit fieldwork was conducted during November 2011 through January 2012.

Our audit is subject to the inherent risk that all significant errors and irregularities, fraud, or non-compliance will not be identified.

Summary of Findings

Although the BEP vendor has systems in place to largely comply with DOR MOR reporting requirements, we identified some key areas of weaknesses in internal controls and recordkeeping and non-compliance with regulations and the MOR instructions. These issues resulted in inaccurate or unsupported reporting of expenses on the MOR in the following areas:

- Net Sales
- Cost of Goods Sold (Inventory & Merchandise Purchases)
- Operating Expenses
- Payroll
- Vendor's Overall Operation

The MOR Instructions state that the BEP Vendor is responsible for the completeness and accuracy of the MOR report. The BEP Vendor's signature on the report signifies the report and attachments are a correct statement of the operation of the vendor's facility and contain valid financial information for the location. The BEP Vendor is responsible for the completeness, accuracy, and submission of the report along with required fees. The BEP Vendor is also required to maintain records to support the reported amounts.

Details on the specific findings identified and recommendations are included in **Appendix A**.

BEP Vendor Response To The Audit

In a teleconference with the BEP Vendor, he provided additional information and appropriate edits are included in the final report. He agreed with the findings as we discussed and is currently working on his corrective action plan. The Vendor has already made changes and will continue to make further improvements to his accounting systems and procedures.

Required Action and Follow-up

To ensure appropriate actions are taken to correct the issues identified in this report, a Corrective Action Plan (CAP) is required. Title 9 Sec 7220 requires that the vendor take all appropriate action to correct any issues identified by a BEP facility review or an audit conducted by the Department within the period of time established by the Department.

1. A CAP must be prepared by the BEP Vendor to address each finding. It must indicate the actions to correct the findings and implement the recommendations identified in this report. The BEP Vendor should consult with BEP staff when developing the CAP to assure that the planned actions will be sufficient to correct the deficiencies noted.

   The CAP is to be submitted by the BEP Vendor to Audit Services by April 11, 2012.

2. DOR will also require the BEP vendor to submit a copy of the MOR for April 2012, along with documentation supporting accurately reported Net Sales, Cost of Goods Sold and Operating Expenses. Audit Services and BEP will review the MOR and supporting documentation to confirm corrective actions were taken and the MOR amounts are reported in compliance with regulations and MOR instructions.

Gary Crocker, BEP VENDOR
Location #3-817, Erreca State Road Side Rest Stop

Details to Findings

Audit Services has conducted an audit of the MORs submitted by the BEP Vendor for the Erreca Safety Road Side Rest Area (SRRA) in Merced County for the period of January 2011 through July 2011. The MORs for the month of February 2011 and July 2011 were selected for detailed review and we noted the following issues:

Net Sales

1. The BEP vendor does not reconcile his cash collected from the machines to the meter readings. Although he collects cash from the machines weekly and reports the amounts collected on a Daily Cash Report, the vendor only documents meter reading on a monthly basis. Further, the vendor does not record meter readings from four machines due to his inability to read the red display.

   Good internal controls require that information obtained on business operations be evaluated. Discrepancies identified between each machine cash count and associated meter reading should be monitored and addressed as appropriate.

2. The MOR Sales Tax (Line 3) was misreported because:

   - The vendor calculated sales tax using a method that is not consistent with Board of Equalization regulations. The vendor calculates the tax rate as $100 / 1.08 - $100 = $7.48 / 3 = $2.26, rather than using the BOE factor method for 33% taxable items.
   - The vendor's cash count spreadsheet tax formula included an arbitrary 8% rate for February 2011 rather than the actual rate of 8.75%.
   - Six vending machines contained items that are taxed at different rates; for example: sodas are taxed at 100% while water is taxed at 33%. Although the BEP Vendor does have a process to calculate the sales tax appropriate for each item, he estimates the tax using ratios of different product type columns rather than calculating sales tax based on the specific items sold.

   BOE Sales and Use Tax Regulations - Regulation 1574 Vending Machine Operators specify requirements for application of tax. Misstatements of gross receipts and sales tax impact accuracy of the MOR including calculations for liability insurance, Profit from Operations, and payment to the Vending Facility Trust Fund. Further, incorrect calculation of sales tax may result in inaccurate reporting on the MOR, and could also result in penalties or administrative action by BOE.

Recommendation

The BEP Vendor has agreed to:

- develop and implement a process for reconciling meter readings to the cash collected.
- ensure the Daily Cash Count template spreadsheet includes the accurate sales tax rate and formulas needed to appropriately calculate sales taxes consistent with BOE requirements; and that the sales tax amounts are accurately reported on the MOR.

Costs of Goods Sold

3. The MOR Merchandise Purchases and Inventory reported in February and July 2011 could not be supported, resulting in inaccurate reporting of Cost of Goods Sold (Line 8).

   a. The amounts listed for Opening Merchandise Inventory (Line 4) and Closing Merchandise Inventory (Line 7) were not supported. Although the BEP vendor stated he conducted the bi-annual physical inventory in June 2011, he stated he did not use the inventory to calculate the ending inventory value required to be reported on the June MOR. At the exit conference, he submitted the June 2011 Master Biannual Inventory Report that included the total inventory value of $15,507. However, the MOR June Ending Inventory and July Opening inventory amounts reported $16,250, resulting in overreported amounts of $743 each month.

      Further, the BEP vendor calculates monthly Ending Inventories and Cost of Goods Sold amounts based on estimate rather than actual costs. The BEP Vendor estimates the Cost of Goods Sold total amount as 48% of net sales and reports the value on MOR line 8. To calculate the reported Ending Inventory amount, the BEP Vendor subtracts line 8 from line 6 Merchandise Available for Sale. The BEP Vendor stated he was using the 48% based on guidance provided by BEP.

      CCR Title 9 Section 7220 (o) requires the vendor to take and report the physical inventory of the vending facility merchandise and supplies twice annually for the periods ending June 30th and December 31st and submit the inventory reports to BEC; and the amount reported must be supported by appropriate records. The MOR Instructions for Closing Merchandise Inventory (Line 7) require that the vendor enter the total amount of the closing merchandise inventory for the report month. Further, Section 7220 (l) requires that the vendor shall maintain required records on the operation of the facility for the current year plus the three preceding years. Such records shall include: (13) supporting records for reported monthly inventory.

Effective internal controls require that a good inventory control system is needed to monitor operations and make informed management decisions regarding operations, including:

- minimizing unnecessary purchases that may result in excess inventory
- minimizing losses due to spoilage or theft
- reducing inventory storage and handling costs

b. Although we could confirm the Merchandise Purchases for February and July 2011 (Line 5) of the MOR to the accountant's monthly income statement totals, we were unable to confirm the amounts reported to the source documents provided by the BEP Vendor.

- February 2011 MOR reported purchases totaling $9,984; however, the supporting documents obtained totaled $7,504 which resulted in a difference of $2,408.

- July 2011 MOR reported purchases totaling $13,008; however, the supporting documents obtained totaled $12,843. which resulted in a difference of $165.00.

Because the vendor did not maintain a journal that included appropriate information for each purchase (vendor, date, amount, invoice number, etc) we were unable to identify specific vendors for which receipts could potentially be misfiled or misplaced.

The CCR Title 9, Section 7220 (l) requires the vendor to maintain required records on the operation of the facility for the current year plus the three preceding years. Such records shall include: (2) Work sheets used to prepare monthly operating reports; (9) Purchase register; and (10) Invoices from purveyors (cash, check and credit purchases).

4. The BEP vendor does not track and monitor loss of merchandise through spoilage, theft, or other loss. He acknowledges the losses he experiences are part of the business and feels that they are ultimately reflected in the bi-annual inventory.

Effective internal controls require that a waste tracking system is needed to monitor operations and make informed management decisions regarding operations, including:

- documenting items lost on a "waste sheet" to properly track, account for, and replace the merchandise lost to spoilage or theft.
- determining what types of items are susceptible to spoilage or theft and how they were lost to help keep product waste low, resulting in increased profitability.

Recommendation

The BEP Vendor has agreed to:

- conduct an extension on future bi-annual inventories to ensure actual values are reported on the MOR.
- develop an effective process, in consultation with his BEP Consultant, to account for and report Monthly Ending Inventory amounts.
- ensure that merchandise purchases are supported by appropriate accounting records and source documents.
- develop a process to monitor and address the loss of merchandise due to spoilage, theft, or other loss when it occurs, including creating and implementing a "waste sheet" to record the merchandise loss.

Operating Expenses

5. The MOR Operating Expenses amounts reported in February and July 2011 could not be supported by source documents, were incorrectly recorded in the accounting records, and in some instances may be unallowable.

   a. The MOR Operating Expenses amounts were not supported by the income statement and/or supporting documents. For example:

      - The July 2011 MOR included Office Expenses totaling $560.00. Although receipts were obtained to support the Income Statement amount of $509.95, we were unable to identify the reason for the difference of $50.05 since the BEP vendor does not maintain a general ledger. The vendor stated the differences may be due to missing receipts.

      - The same amount ($431.00) was reported on the Transportation line item each month from January through July 2011. The BEP vendor stated the monthly amount is based on estimated mileage costs determined by multiplying the daily round trip mileage to the vending machine locations by the IRS mileage rate. This amount is then multiplied by the planned days he travels to the sites, typically three days a week. The vendor stated he did not maintain a mileage log since the van is used solely for the business. Although the amount appears reasonable if the vendor consistently travels to the sites as planned, the BEP Vendor is not reporting transportation costs based on actual mileage as required by the MOR instructions.

b. The MOR Repairs and maintenance expenses incurred in July for repairing the vending machines and locations are supported by source documents; however, since the vendor did not obtain prior BEP approval these expenses could be considered unallowable.

CCR Title 9, Section 7220 (l) requires the vendor to maintain required records on the operation of the facility for the current year plus the three preceding years to include invoices and records for operation purchases. Such records shall include: (2) Work sheets used to prepare monthly operating reports and (10) Invoices from purveyors (cash, check and credit purchases). Further, Section 7217.1. Equipment Repair and Replacement requires that: (a) The vendor shall promptly inform the BEP of the need for equipment repairs or replacement. The vendor shall contact his/her BEC to report equipment malfunction/failure. Upon notification by the vendor of the need for equipment maintenance, the BEC shall promptly authorize repair; and, (f) The BEP shall provide all necessary repairs and replacement of BEP-owned equipment.

The Vendor's MOR Instructions identify Non-Deductible Expenses including items such as commuting to and from work and unauthorized vehicle mileage or repair. The BEP training guidance allows mileage between the warehouse, the location, and back.

Recommendation

The BEP Vendor has agreed to:

- ensure Operating Expenses reported on the MORs are accurate, allowable, and supported by accounting records and source documents.
- establish and maintain proper mileage records to accurately report and support the MOR Transportation Expenses.
- notify and obtain appropriate approval from BEP regarding necessary repairs and maintenance of vending machines and other State-owned equipment.

Payroll

6. Although the BEP vendor does have time-keeping records to support wages, we noted the following concerns:

- the manner in which the time worked was recorded was not appropriate since employees document hours worked on a blank steno pad page. The page only identified their first name, month, date and number of hours worked but did not include the year, work starting/ending times (including breaks and lunch), and lacked employee and vendors signatures.

- In 4 instances, employees were paid an excess of 5 additional hours than what was stated on their timesheets. The BEP Vendor stated that he felt this was an acceptable method to reward his employees for performing well.

Inadequate timesheets and improper payment of wages beyond what is worked could place the BEP Vendor in serious jeopardy to receive allegations of labor law violations.

California Code of Regulations Title 9 states that the Vendor must maintain compensation records to support payroll expenses. Without such records there are no recognition that the employee indeed worked the number of hours stated or that the hourly wage is supported.

29 CFR 516.2(a)(7) requires every employer to maintain and preserve Payroll or other records containing the following information and data with respect to each employee. Hours worked each workday and total hours worked each workweek (for purposes of this section, a ``workday'' is any fixed period of 24 consecutive hours and a ``workweek'' is any fixed and regularly recurring period of 7 consecutive workdays).

Recommendation

The BEP Vendor has agreed to:

- Create, implement, and maintain employee timesheets/timecards that contain the required elements as defined by Labor Law regulations.
- Research appropriate method(s) to reward employees.

Vendor's Overall Operation

7. The BEP vendor does not maintain an adequate accounting and record keeping system to sufficiently account for, track, and support expenses reported on the MORs and provide for an effective audit trail. We noted the following concerns:

    - Although the BEP vendor reports expenses using the accrual method, some items were not recorded in the proper month incurred. The BEP Vendor stated he may sometimes overlook an invoice and submit it late to the accountant, who then includes the amount in the current income statement rather than the appropriate period incurred. Accrual accounting requires that expenses must be recorded in the period incurred to give the most accurate picture of the financial state of the BEP Vendor's business.
    - The accountant's office uses an adding machine to compute amounts for expenses which are then reported in total on a monthly Income Statement. Because the adding machine tapes only included total dollar amounts, we were unable to verify that all MOR Merchandise Purchases and Operating

Expense amounts were supported by source documents. Without an appropriate accounting system that includes appropriate accounting records such as a general ledger and subsidiary journals, a sufficient audit trail is not maintained to allow DOR to confirm the MOR reported amounts are fully supported.

Recommendation

The BEP vendor has agreed to, in consultation with BEP program:

- ensure invoices and other source documents are recorded in the month incurred. If an invoice is found after that month's MOR has been submitted to DOR, the BEP Vendor should revise the accounting records for the applicable period and submit an amended MOR to reflect the adjustment.
- establish and maintain accounting records to list and track specific expenses that will provide a sufficient audit trail which supports the MOR reported amounts.

8. Although the MOR Instructions require that the BEP Vendor sign the MOR, the accountant has been signing the MOR's for the vendor or has left the signature line blank. Currently, the vendor mails his source documents to his accountant sometime after the end of the month. The accountant's office reviews the source records; and computes, allocates, and records total amounts to applicable Income Statement account line items. Finally, the accountant completes the MOR, and mails it to DOR. We identified the accountant only signed three out of the seven MORs and the rest had no signatures. The accountant's office then mails a copy of the MOR and source documents back to the BEP vendor. As a result, the BEP vendor is not reviewing the MOR information nor signing it prior to being submitted to DOR.

The MOR instructions require that the vendor must sign name and date the report. The vendor's signature on the report signifies the reports and attachments are a correct statement of the operation of the vendor's facility and contains only valid financial information for the location. An unsigned or incomplete report will not be accepted and will be returned to the vendor for completion.

Recommendation

The BEP Vendor has agreed to evaluate his MOR preparation process and make improvements to ensure he reviews and signs the MOR and submits them timely.