



Lawrence F. Alwin, CPA
State Auditor

An Audit Report on University Contract Administration

March 18, 2002

Members of the Legislative Audit Committee:

The results of our statewide survey of higher education institutions (excluding community colleges), as well as our audits at the University of Houston and The University of Texas Medical Branch at Galveston, highlight the need for institutions to establish good contracting processes and enforce them through proper oversight.

- Seven of the 61 (11 percent) institutions we surveyed did not have contracting policies and procedures.
- The two institutions we audited had contracting policies and procedures, but they did not consistently follow their procurement procedures. At these institutions, we found contracts that were not reviewed by the central contracting office prior to execution; contracts for which sole source justifications were prepared after contract execution; and contracts with signatures that were not properly authorized, were not recorded after the contract was executed, or were missing.
- Neither institution we audited had established detailed guidance on how to monitor contracts.
- The University of Texas Medical Branch at Galveston had not consistently established contract provisions to ensure that it could impose adequate sanctioning and spending restrictions on the contractors.

Not having or following adequate contracting policies and procedures increases both financial and service risk at these institutions. As a result, universities risk not hiring quality contractors, paying more than is necessary for goods or services, not receiving needed services, and losing and wasting state funds.

The weaknesses in contract administration we identified at higher education institutions mirror the weaknesses we have identified in previous audits of contracting at state agencies. However, higher education institutions could be at higher risk than state agencies for inappropriate use of contracting funds because:

- Higher education institutions are typically decentralized, which can complicate the establishment, communication, and enforcement of contracting policies and procedures.

The Reported Dollar Value of Higher Education Institution Contracting May Not Be Accurate

We were unable to accurately determine how much higher education institutions spend on contracts. Information in the Texas Building and Procurement Commission's Historically Underutilized Business (HUB) database indicates that higher education institutions reported they contracted for an average of \$1.7 billion annually from fiscal year 1997 through fiscal year 2000.

However, we did not audit this \$1.7 billion figure, and prior State Auditor's Office audits have raised concerns about the reliability of the information in the HUB database. Unfortunately, the HUB database is the only statewide database to which higher education institutions and agencies must report all contracts. We have discussed the lack of a comprehensive, reliable statewide contracting database in previous audit reports.



- Higher education institutions are not required to follow the same requirements for purchasing and contracting that state agencies must follow. Before September 1, 2001, most health-related institutions were exempt from some of the state purchasing and contracting laws that apply to state agencies. Effective September 1, 2001, all higher education institutions became exempt from the same requirements from which health-related institutions were exempt.

Despite the exemption from certain state purchasing and contracting laws, the law requires higher education institutions to “acquire goods or services by the method that provides best value to the institution.” To achieve this, each institution needs to carefully document, communicate, and enforce its self-defined procedures within its individual organization. Each institution must also ensure that its defined processes adhere to good business practices.

We recommend that all higher education institutions assess their contract administration policies and procedures and implement identified improvements. The State Auditor’s Office contract administration model (see Figure 1) serves as a guide to good contracting practices. Our contract administration audits are based on this model, and we make statewide contracting training available for state entities.

The attachment to this letter contains additional details on the results of our survey and audit. It also includes additional contract administration guidance for higher education institutions. We provided specific recommendations in management letters to both institutions where we conducted on-site audits. Management generally agrees with our recommendations. If you have any questions, please call Carol Noble, Audit Manager, at (512) 936-9500.

Sincerely,

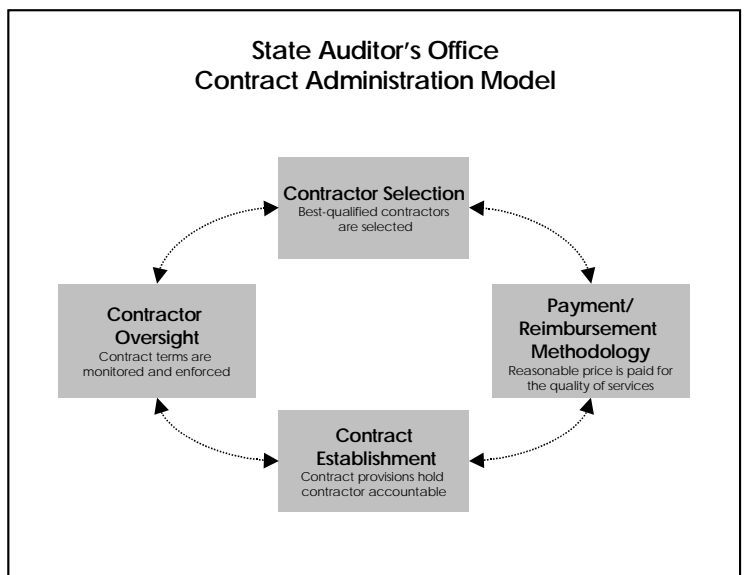
Lawrence F. Alwin, CPA
State Auditor

cbg

Attachment

cc: Chancellors and Presidents at
Health-Related and Four-Year Higher Education Institutions

Figure 1



Section 1:

Higher Education Institutions Should Judiciously Execute Each Phase of the Contract Administration Process

The issues identified during this contract administration audit reinforce the need for stronger contract administration controls in higher education. The State cannot afford to overlook instances in which institutions fail to implement all components of an effective system of contract administration.

Definition of Higher Education Institutions

For purposes of this report, the phrase "higher education institutions" refers to both universities and health-related institutions. Community and technical colleges were not within the scope of this audit.

Section 1-A:

Higher Education Institutions Should Assess Their Contracting Practices Using the Four-Phase Contract Administration Model and Should Implement Needed Improvements

In previous State Auditor's Office reports, we have outlined the four key phases and objectives of contract administration (see Table 1). These key phases and objectives also apply to higher education institutions' administration of contracts for goods and services.

Table 1

Key Phases of Contract Administration	
Phase	Objective
Contractor Selection	The procurement process should be sufficient to ensure that the best contractors are selected fairly and objectively.
Contract Establishment	Contract provisions and institution regulations should be sufficient to hold contractors accountable for delivery of quality services and should prevent the inappropriate or inefficient use of public funds.
Payment/ Reimbursement Methodology	Methods used to establish contractor reimbursement should be sufficient to ensure that the State pays a fair and reasonable price for service.
Contractor Oversight	Contractor oversight should be sufficient to ensure that contractors consistently provide quality goods and services (by measuring performance against well-documented expectations) and that public funds are spent effectively and efficiently.

Source: State Auditor's Office

We recommend that all higher education institutions assess their contract administration policies and procedures and implement identified improvements. The State Auditor's Office contract administration model serves as a guide to good contracting practices. Our contract administration audits are based on this model, and we make statewide contracting training available for state entities.

It is important that institutions become aware of the risks they assume as a result of their approach to each contracting phase. Table 2 at the conclusion of this section summarizes the risk levels associated with different approaches to managing each of the phases. To guide institutions in implementing contracting best practices, Table 3

at the conclusion of this section presents practices that institutions should consider when executing each phase of contract administration.

Each of the four phases of the Contract Administration Model is discussed in detail below.

Contractor Selection

Eleven percent of the institutions we surveyed did not have contracting policies and procedures for departments to follow when selecting contractors. In addition, the two institutions we audited had contracting policies and procedures, but they did not consistently follow their selection procedures.

The procedures institutions use to select contractors must ensure the best contractors are selected fairly and objectively. Formal procedures to assess prospective contractors' strengths, weaknesses, and past performance must be established to provide assurance that the contractors can perform the job. When feasible, and unless otherwise prohibited by law or other restrictions, competition among contractors should exist for state contracts.

Contract Establishment

Without established contracting policies and procedures (a condition that existed at 11 percent of the institutions we surveyed), institutions can not provide sufficient guidance for departments to follow when writing contract provisions. Although The University of Texas Medical Branch at Galveston had contracting policies and procedures, this institution had not consistently established contract provisions to ensure that it could impose adequate sanctioning and spending restrictions on contractors. We found no issues regarding contract provisions at the University of Houston.

The provisions of institutions' contracts must be sufficient to hold contractors accountable for delivery of quality goods and services and to prevent inappropriate and ineffective use of public funds. Contracts with inadequate provisions permit contractors to legally and contractually use public funds in a manner not consistent with the best interest of the State or the citizens who are eligible to receive services.

Contract Payment/Reimbursement Methodology

Forty-nine of the 61 (80 percent) institutions we surveyed reported that they used fixed pricing arrangements in their contracts. While fixed pricing arrangements are not necessarily inappropriate, institutions must be aware that these types of pricing arrangements typically carry the highest risk (see Table 2 on page 5).

We found no significant problems with contractor payment methodologies at the University of Houston and the University of Texas Medical Branch at Galveston.

Before entering into contracts, institutions must establish contractor payment methodologies that are sufficient to ensure that the State pays a fair and reasonable price for contracted goods and services. To achieve this, institutions must analyze the cost of the good or service, as well as the type of service when applicable, to

determine the most effective payment methodology. No single best contract payment methodology can be applied to all contracts. Therefore, institutions must assess the strengths and weaknesses of various payment methodologies (such as cost reimbursement or payment per unit of service) and determine which methodology is the most advantageous for each individual program.

Under a fixed pricing arrangement, the contractor receives a lump-sum payment or fee for providing a good, performing a set of tasks, or delivering a certain number of services (without regard to the contractor's actual cost of delivering the good or service). The risk to the institution is in ensuring that the outcomes, quality, and quantity of goods or services delivered are satisfactory. Contractors have an incentive to control costs, but there is an increased risk of lower quality. This increases the importance of monitoring performance based on well-defined performance and quality measures.

Contractor Oversight

The lack of established contracting policies and procedures at 11 percent of the institutions in our survey means there is insufficient guidance for departments to follow when monitoring contractors. Both the University of Houston and The University of Texas Medical Branch at Galveston required departments to monitor contracts. However, both institutions need to expand their policies and procedures to offer more detailed guidance on *how* to monitor contracts.

Throughout the life of its contract, the institution must diligently and regularly monitor both the quality of other services contractors provide and whether contractors are using public funds effectively and efficiently. When institutions identify contractors that are not meeting these expectations, they should impose sanctions upon these contractors. When contractors demonstrate repeated inability to meet these expectations, they should be denied the privilege of contracting with the State.

Monitoring procedures should be designed to ensure compliance with all significant contract provisions, program requirements, and financial-related requirements. Procedures should:

- Clarify roles and responsibilities for the various monitoring functions.
- Define a risk assessment methodology for determining the cost-effective level of monitoring for each contract.
- Ensure that monitoring results are reported to key individuals within the institution.

Section 1-B:

Higher Education Institutions Should Establish, Strengthen, and Enforce Adequate Contracting Policies and Procedures

Establishing adequate contract administration policies and procedures for all four contracting phases is the first step in ensuring that higher education institutions acquire the quality goods and services needed to achieve their mission. As mentioned

above, seven of the 61 (11 percent) higher education institutions we surveyed reported that they have no contracting policies and procedures.

Although the University of Houston and The University of Texas Medical Branch at Galveston have established contracting policies and procedures, we identified opportunities for both to enhance this written guidance, particularly in the area of contract monitoring. Not having adequate contracting policies and procedures increases the risk that institutions:

- May not obtain the best contractor for the job.
- May pay the contractor more than is reasonable.
- May not adequately monitor the quality of the contractor's goods or services.
- May not receive needed goods or services in a timely manner.
- May be unable to hold the contractor or their own personnel accountable for inadequate goods or services.
- May expose the institution to fraud or abuse of funds.

Once adequate contracting policies and procedures have been established, institutions need to enforce these policies and procedures through proper oversight of the contract administration function. The decentralized environment and large size of higher education institutions make enforcement and oversight challenging.

While internal audit departments should be neither the primary oversight source nor the sole enforcer of contracting policies and procedures, they play an indirect role in the proper oversight of the contract administration function. Thirty-two of the 61 (52 percent) institutions we surveyed reported that their internal audit departments had conducted contracting audits during the past three years. We encourage internal audit departments that have not conducted contracting audits to include contract administration in the risk assessments they perform to determine which audits they will conduct.

Table 2

Risk Levels Associated With Different Approaches to Contracting Phases				
Risk Level	Phases			
	Contractor Selection	Payment/ Reimbursement Methodology	Contract Establishment	Contractor Oversight
High	Sole Source	Unit/Fixed Rate		No Oversight
	Enrollment			
	Non-Competitive Award	Unit/Fixed Rate With Reasonable and Necessary Clause		Fiscal Only
	Negotiated	Advance		Program Only
		Reimbursement (Approved Budget)	Reasonable and Necessary Clause	Fiscal and Program
	Request for Proposal			Random Fiscal and Program
Low	Competitive Bid	Reimbursement (Actual Expenditures)		

Source: Texas Senate and Texas House of Representatives, Joint General Investigating Committee, *Report on State Contracting*, October 14, 1996.

Table 3

Contract Administration Recommended Best Practices	
Key Area	Best Practices
Contractor Selection	<p>Whenever feasible, and unless otherwise prohibited by law or other restrictions, contractors should be selected through competitive procurement proceedings.</p> <p>Past performance should be considered in subsequent selection/contract renewal decisions.</p> <p>Formal, documented procedures should be used to assess prospective contractors' strengths and weaknesses.</p>
Payment/ Reimbursement Methodology	<p>Prior to the contract award, the cost of goods or services, as well as the goods or services themselves, should be analyzed in order to determine the most effective payment methodology.</p> <p>Approval of proposed contractor budgets should focus on ensuring that proposed expenses are reasonable and necessary to accomplish program objectives. Both program results and contractor efficiency should be considered as part of the budget approval process.</p> <p>For unit-rate contracts, the rate-setting process should ensure that there is a reasonable correlation between the quality of the services provided, the costs of providing the services, and the rate paid.</p>
Contract Establishment	<p>Clear statements of services and goods expected from the contractor should be included in contracts.</p> <p>Clearly defined performance standards and measurable outcomes should be included in contracts.</p> <p>Clear statements describing how contractor performance will be evaluated should be included in contracts.</p> <p>Contracts should include sanctions sufficient to hold contractors accountable for failing to meet intended objectives.</p> <p>Contracts should include appropriate restrictions regarding contractors' use of public funds.</p> <p>Contracts should include specific audit clauses that allow the funding agency and other oversight entities access to contractor books and records.</p>
Contractor Oversight	<p>Monitoring functions should focus on the outcomes of services provided and the cost-effectiveness/prudence of contractor expenditures in addition to compliance with regulations.</p> <p>Results of monitoring reviews, audits, and investigations should be routinely followed up on to ensure corrective actions have been taken and to identify common problem areas.</p> <p>A formalized risk assessment process should be used to select contractors for review and identify the level of review necessary for each contractor.</p> <p>Standardized criteria should be established to evaluate contractor performance.</p>

Source: State Auditor's Office

Summary of Objectives, Scope, and Methodology

Our objectives were to determine whether:

- Institutions' procurement processes ensure that the best contractors are selected fairly and objectively.
- The methods institutions use to establish contract payments ensure that the State pays a fair and reasonable price for the goods and services.
- Institutions' contract provisions and regulations hold contractors accountable for delivery of quality services and prevent the inappropriate or inefficient use of public funds.
- Institutions establish contractor oversight to ensure that contractors consistently provide quality goods and services (by measuring performance against well-documented expectations) and that public funds are spent efficiently and effectively.

To accomplish these objectives, we surveyed 61 institutions and conducted on-site audits at the University of Houston and The University of Texas Medical Branch at Galveston.

Our on-site audits included testing of goods and services contracting activities that occurred from September 2000 through March 2001. Fieldwork was conducted from June 6, 2001, through September 15, 2001. We conducted this audit in accordance with generally accepted government auditing standards.

A change in statutory requirements became effective September 1, 2001. Texas Education Code, Section 51.9335, exempts higher education institutions from certain goods and services procurement statutes applicable to state agencies. Specifically, it states that "An institution of higher education may, but is not required to, acquire goods and services as provided by Chapters 2155, 2156, 2157, 2158, 2167, and 2170, Government Code." Chapters 2155, 2156, 2157, and 2158 apply to contracting and set forth requirements such as purchasing rules and procedures, purchasing methods, the purchase of automated information systems, and purchases of certain goods and services. Texas Education Code, Section 51.9335, formerly applied only to medical and dental components of higher education institutions. Through House Bill 1545 (77th Legislature, Regular Session), the Legislature expanded this code section to apply to all higher education institutions (excluding public junior colleges and The University of Texas M. D. Anderson Cancer Center).