

An Audit Report on

The Capital Access, Defense Economic Adjustment Assistance Grant, and Tourism Programs at the Department of Economic Development

May 2003

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**State
Auditor's
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The Capital Access, Defense Economic Adjustment Assistance Grant, and Tourism Programs at the Department of Economic Development

Overall Conclusion

The Department of Economic Development's (Department) management of its Capital Access Program did not consistently ensure that the Department (1) spent the program's funds in accordance with laws and regulations, (2) reported reliable results for the program, or (3) held lenders accountable for performance. This program contributed \$1.2 million to loan loss reserve accounts for enrolled loans in fiscal years 2001 and 2002. Specifically, we noted that:

- In fiscal years 2001 and 2002, the Department did not ensure that all borrowers and their loans were eligible before using state funds to enroll them in the Capital Access Program. We identified contributions to loan loss reserve accounts totaling \$121,773 for loans that were ineligible, that lacked sufficient information to determine the loan's or borrower's eligibility at the time of enrollment, or for which contractually required documents were not submitted prior to enrollment. Additionally, three of the loans cited above defaulted and resulted in claims totaling \$305,980 against the loan loss reserve accounts, which are state property.
- Results reported for this program are not reliable because the Department based the jobs created on projections and did not verify the underlying data for the leverage ratio.
- The Department did not begin monitoring lenders until fiscal year 2002.

Background

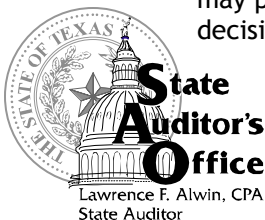
The **Capital Access Program** provides access to capital for small and medium businesses and nonprofit organizations that may otherwise fall outside conventional lending guidelines.

The **Defense Economic Adjustment Assistance Grant** program provides grants to adversely affected defense-dependent communities for projects such as purchasing property from the U.S. Department of Defense or its designated agent, rehabilitating or renovating facilities or infrastructure, and purchasing capital equipment.

The Department's **Tourism** division promotes Texas tourism by non-Texans. It accomplishes this through a variety of methods, including advertising both domestically and internationally and by conducting public relations campaigns.

While the Department generally spent funds in accordance with laws and regulations and held contractors accountable for performance in the Defense Economic Adjustment Assistance Grant (DEAAG) and the Tourism programs, the Department did not perform sufficient monitoring to ensure that reported results for these programs are reliable. For fiscal years 2001 and 2002, the Department spent \$7.4 million on DEAAG grants and \$33.3 million on Tourism contracts.

Additionally, the financial account balances in the Department's internal accounting system are not reliable because the Department did not perform its year-end accounting close-out procedures for fiscal year 2001. For this reason, the Department had to use the Uniform Statewide Accounting System to prepare its fiscal year 2002 Annual Financial Report. The Department's internal accounting system should be the main source of information for budget analysis and financial data vital to effective management decisions. Due to the unreliability of financial account balances, the Department's accounting system may provide misleading information for analyzing budgets and making management decisions.



Summary of Information Technology Review

The Department's application controls over the Capital Access Database do not ensure that management has accurate and reliable data to make decisions. Because we noted weak controls, we tested the accuracy of the database. Although we did not find significant errors in the Capital Access Database for fiscal years 2001 and 2002, the Department's insufficient controls put the accuracy of future data at risk.

The Department did not test its disaster recovery plan within the last year as required by Texas Administrative Code [Title 1, Part 10, Rule 202.6(a)(5)(E)].

Summary of Management's Responses and Auditor's Follow-Up Comments

The Department generally agrees with our recommendations. However, the Department disagrees with one of the issues identified in our audit. In Chapter 3-A, the Department agrees to implement our recommendations but states that it believes the calculation of the return on investment for the Tourism program is reliable. However, the Department failed to provide evidence to support the processes described in its response while the audit team was collecting, testing, and analyzing information to meet the Tourism audit objectives.

Summary of Objectives, Scope, and Methodology

The audit objectives were to review contract and grant management and financial transactions of the Capital Access, Defense Dependent Communities, and Tourism programs at the Department to determine:

- Whether grantees and contractors are held accountable for performance.
- How program results are calculated and whether they are based on accurate and reliable data.
- Whether funds are spent in accordance with contract terms and applicable laws and regulations.

The scope of our audit included the Capital Access, Defense Economic Adjustment Assistance Grant (DEAAG), and Tourism programs. Our methodology consisted of conducting interviews; collecting and reviewing information; and performing tests, procedures, and analyses against predetermined criteria. This audit was conducted in accordance with generally accepted government auditing standards.

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Detailed Results

Chapter 1

Capital Access Program

The Department of Economic Development (Department) did not always spend Capital Access Program funds in accordance with contract terms and applicable laws and regulations in fiscal years 2001 and 2002. One of the Capital Access Program's reported results, the number of jobs created and retained, is not reliable because it is based on projections rather than actual results. The Capital Access Program's other measure, its leverage ratio, might not be reliable because the Department did not verify the underlying data. The Department did not begin holding lenders accountable through monitoring until fiscal year 2002. In addition, the processes it implemented in fiscal year 2002 did not include regular reviews of support for enrollment of loans and claims for defaulted loans. Improved monitoring would increase the reliability of reported results and would help the Department ensure that it spends funds in accordance with applicable laws and regulations. The Capital Access Program expended \$1.2 million on state contributions in fiscal years 2001 and 2002.

Capital Access Program

The Capital Access Program provides access to capital for small and medium businesses and nonprofit organizations that may otherwise fall outside conventional lending guidelines.

When a lender enrolls a loan in the program, the borrower, the lender, and the State contribute a percentage of the loan into a loan loss reserve account held at the lender's facility. Each lender has one account containing the pooled contributions for all of the lender's enrolled loans. If a loan in the lender's enrolled portfolio defaults, the lender may make a claim against the loan loss reserve account. All enrollments and claims are subject to the Department's approval.

Chapter 1-A

The Department Did Not Always Spend Capital Access Program Funds in Accordance with Contract Terms and Applicable Laws and Regulations

In fiscal years 2001 and 2002, the Department did not always spend Capital Access Program funds in accordance with contract terms and applicable laws and regulations. We identified contributions to loan loss reserve accounts totaling \$121,773 for loans that were ineligible, that lacked sufficient information to determine the loan's or borrower's eligibility at the time of enrollment, or for which contractually required documents were not submitted prior to enrollment. In addition, it did not verify the enrollment information that it did receive. Three of the loans cited above defaulted and resulted in claims totaling \$305,980 against the loan loss reserve accounts, which are state property. Texas Administrative Code (Title 10, Part 5, Rule 187.9) requires the Department to ensure the completeness of enrollment forms, the eligibility of the applicant, the qualified use of the proceeds, and compliance with statutes and rules.

Specifically, our test for fiscal years 2001 and 2002 revealed three types of noncompliance with laws and regulations:

- The Department contributed \$100,753 to loan loss reserve accounts for loans not allowed by statute or loans for which there was insufficient information to determine the loan's eligibility at the time of enrollment. As a result of our test, we estimate that out of all the loans made in fiscal years 2001 and 2002, the Department contributed as much as \$290,992 for ineligible loans or loans with insufficiently documented eligibility. Furthermore, three of these loans defaulted and resulted in claims totaling \$305,980 against the loan loss reserve accounts.

Many of the ineligible loans were the result of the Department making a rule in the Texas Administrative Code that conflicts with statute. Government Code, Section 481.407(b), does not allow borrowers to use the Capital Access Program to refinance non-Capital Access Program loans. However, Texas Administrative Code [Title 10, Part 5, Rules 187.3(c) and 187.4(e)] allows the enrollment of such loans if the original loan was made by a different lending institution. Contributions for ineligible refinancing of loans totaled \$36,546.

As part of the re-engineering efforts it initiated in fiscal year 2002, the Department obtained the missing information for the enrolled loans that were lacking documentation. While some of these loans were in fact eligible, the Texas Administrative Code (Title 10, Part 5, Rule 187.9) requires the Department to ensure that the enrollment forms are complete when it receives them.

- The Department contributed \$19,560 for loans without sufficient information to determine the borrowers' eligibility at the time of enrollment. The enrollment forms were missing information required to determine the size of the businesses.
- The Department contributed \$7,820 for loans before it received all documents required by the contracts.

Additionally, the Department's application controls over the Capital Access Database do not ensure that management has accurate and reliable data to make decisions. For example, there was no automatic calculation or verification of the contribution amounts and percentages, including the State's contribution. Three lenders' eligibility for increased state contributions were incorrectly recorded in the Capital Access Database. As a result, the Department overpaid the State's contribution to two lenders (not related to the sample test above) by \$9,226 and underpaid the State's contribution to one lender by \$2,200. These incorrect payments could have been prevented by automatic determination of the lenders' eligibility status and calculation of the State's corresponding contribution.

The absence of logical controls also puts the reliability and accuracy of the data in the database at risk. Because we noted weak controls, we tested the accuracy of the database. Although we did not find significant errors in the Capital Access Database for fiscal years 2001 and 2002, the accuracy of future data is at risk if sufficient controls are not implemented.

In addition to not always getting complete enrollment information from lenders and borrowers, the Department did not obtain support for the enrollment information it did receive. It also did not get support for the claims against the loan loss reserve accounts. The Department's monitoring did not include reviewing such support (see

Chapter 1-C for further information). Reviewing the information on the enrollment forms would help ensure that only eligible loans are enrolled in the Capital Access Program and would help ensure the reliability of reported results (see Chapter 1-B). A review of information related to claims for defaulted loans is especially important because these claims involve using the loan loss reserve accounts to reimburse lenders' losses. Examples of the evidence that the Department could obtain or review include:

- Loan documents, titles, and liens as appropriate.
- Lender loan files, which often include certificates of incorporation or other evidence of the existence, size, and purpose of the business (which may affect the amount of the State's contribution).
- Minutes of the lender board meetings documenting the discussion of the default of loans, copies of letters declaring loans in default, and copies of legal documents showing lenders' efforts to make recoveries on defaulted loans.

Recommendations

The Department should:

- Ensure that enrollment forms and related exhibits are completely filled out.
- Review forms carefully to ensure that the loans are eligible for the Capital Access Program prior to enrollment.
- Implement logical controls in its Capital Access Database to ensure that the data in the database continues to be reliable and accurate.
- Obtain additional assurance that information reported on enrollment forms and claim forms is accurate and reliable.

Management's Response

The Department concurs. Some recommendations have already been implemented and the others are in progress. Program staff has been trained on eligibility and reporting requirements, and will review enrollment forms for compliance prior to enrollment. An enrollment checklist has been developed to ensure receipt of all information required to establish eligibility prior to enrollment. In March 2002, the Department began a self-audit with an inventory and reconciliation of all Capital Access Program loans. As a result, management became aware that some documents required for loan enrollment and/or qualification were missing or incomplete. Deficiency spreadsheets were developed to identify all missing or incomplete documents for each lender and the lenders were then requested to supply any missing information or documents. To date, this effort has produced all the documents required to show the eligibility of loans with reserve contributions by the State of \$72,027 out of the \$121,773 identified by the State Auditor's Office (SAO) as either ineligible or lacking sufficient information to determine eligibility at the time of enrollment.

With regard to the remaining \$49,746 (\$121,773 - 72,027) identified by the SAO, Departmental policy and Staff training now excludes refinancing of loans from eligibility unless the loan was originally enrolled in the Capital Access Program. The Department intends to revise the rule at 10 TAC Section 187.3(c)(3) to be in compliance with the statute. The Capital Access Program rules were first proposed in July 1997 and adopted in September 1997; shortly after the statute authorizing the program was enacted. Comments to the proposed rules noted that the regulations in other states' capital access programs, on which the Texas program was modeled, prohibited a lender from refinancing its own pre-existing debt but allowed the enrollment of loans financed from another institution. This would allow, for example, refinancing of a business that had previously been financed using credit card debt. The comments urged the Texas program to follow the model and clarify in the rules that refinancing of existing loans was permissible if another lender originally made the loan. Based on these comments, the Texas rule, 10 TAC Section 187.3(c)(3), was written to provide that taking over or refinancing the indebtedness of eligible borrowers held at unrelated financial institutions would not be defined as refinancing.

In April 2002, the Department began adding logical controls to the Capital Access database. These include data input masks, field defaults, input field limits and input calculation controls. Other database modifications improvements have been made and the process is ongoing.

Additionally, standard operating procedures and a claims checklist have been developed. An important control process for claims verification has been initiated, requiring lenders to submit collection letters, bankruptcy documentation and/or proof of loan default for any claim against the loan loss reserve account. Site visits to hold lenders accountable will continue on a regular basis and training for each lender will be provided on the Capital Access Program requirements for eligibility, documentation and reporting.

The Department Did Not Report Reliable Results for the Capital Access Program

One of the Capital Access Program's reported results (jobs) is not reliable because the Department calculates it using projections rather than actual results. The Department also did not ensure the reliability of its other program result, the leverage ratio. Additionally, the Department did not report funds held outside the state treasury in its Annual Financial Report.

Jobs. The number that the Department reports for its "jobs" result is not reliable because the Department used borrowers' projections—rather than actual numbers—to calculate it. (At the time of enrollment, borrowers project the number of jobs they will create and/or retain as a result of the loan.) The Department did not obtain support for the borrowers' projections, and it did not review support through on-site monitoring visits.

Without some support or verification that projected results have been achieved, these projections are meaningless. A test performed at one lender facility revealed that the lender also did not obtain supporting documentation for this figure. As a result, the Department cannot verify that any jobs have been created as a result of this program.

Capital Access Program Results

The Department reports program results through its annual report for the Capital Access Program.

The "jobs" result is calculated by totaling the number of jobs created and retained as reported on loan enrollment forms.

The leverage ratio (sometimes referred to as the cost-benefit ratio) is calculated by dividing the sum of the total investment reported on all loan enrollment forms for a fiscal year by the sum of all state contributions to lenders' loan loss reserve accounts. This measures the dollars loaned as a result of the State's contributions to the loan loss reserve accounts.

Furthermore, the Department did not have procedures or definitions in place to standardize borrowers' projections:

- The Department did not have procedures or definitions for reporting the jobs created and/or retained when a borrower purchases an existing business.
- The Department did not have procedures for dealing with multiple loans to the same recipient in order to prevent double-counting.

The number of jobs created and retained may not be a meaningful measure for the program. The Department does not have direct control over the borrowers, who ultimately create the jobs, because its contracts are with the lenders.

Leverage Ratio. The Department did not obtain supporting documentation for the total investment (total amount of the borrower's loan) reported on enrollment forms, nor did it review this documentation through on-site monitoring visits in fiscal years 2001–2002. Because the Department uses the total investment to calculate the leverage ratio, the leverage ratio may be unreliable. Because the controls over the enrollment process were weak (see Chapter 1-A), we expanded our testing to include a review of documentation at one participating lender. Although we did not identify specific errors related to the amount of the loans at this lender, the Department does not know for sure that it is achieving the results it reported without a review of the supporting documentation.

Annual Financial Report. The Department did not report funds held outside the State Treasury in its Annual Financial Report. The total of cash in loan loss reserve accounts held at financial institutions was approximately \$1.4 million at the end of fiscal year 2002. The Department, the lender, and the borrower contribute money to a loan loss reserve account for loans that are enrolled in the Capital Access Program. The Department uses the accounts to reimburse lenders for enrolled loans that default. These accounts, and the money in them, are state property, but the Department did not reflect this activity in its fiscal year 2002 Annual Financial Report. Funds deposited into the loan loss reserve accounts from sources other than the State totaled approximately \$400,000, and net withdrawals for defaulted loan claims totaled \$1.5 million.

Recommendations

The Department should:

- Consider whether the number of jobs created and retained is a meaningful measure of the success of the Capital Access Program. If so, the Department should develop definitions, policies, and procedures to standardize the reporting of this figure and ensure that actual jobs are tracked rather than projected jobs. Finally, it should obtain and/or review supporting documentation for the reported jobs.
- Obtain assurance that the total investment reported on enrollment forms is reliable either by obtaining supporting documentation at the time of enrollment or through periodic monitoring as discussed in Chapters 1-A and 1-C.
- Work with the Comptroller of Public Accounts to determine procedures for accounting for funds held outside the State Treasury and reflecting this activity in its Annual Financial Report.

Management's Response

Job creation or retention is not a requirement for participation in the program, nor is it a performance measure of program. The department will eliminate this information from the program's enrollment forms and the Capital Access Program Annual Report.

On a sample basis, the Department will conduct periodic monitoring to verify that the information on file at participating lenders adequately substantiates the total investment reported on the enrollment form. A monitoring form has been developed, which will assist in reviewing the total investment information for reliability, as well as provide documentation of the review.

The Department will consult with the Comptroller of Public Accounts to determine the proper accounting treatment for the Capital Access Program funds held in the Loan Loss Reserve Accounts. The future Annual Financial Reports will present these funds in the manner prescribed by the Comptroller of Public Accounts.

The Department's Monitoring Did Not Hold Lenders and Borrowers Fully Accountable

While the Department's contracts contain sufficient provisions to hold lenders accountable, the Department did not monitor lenders prior to fiscal year 2002. As a result, lenders were not submitting statutorily required reports and were making unauthorized withdrawals. However, in fiscal year 2002, the Department began ensuring that lenders submit required reports, remit interest to the State, and make only authorized deposits to and withdrawals from loan loss reserve accounts. It also required lenders to correct identified problems, including returning unauthorized withdrawals. State contributions to the loan loss reserve accounts prior to fiscal year 2002 totaled approximately \$2 million.

Although the Department began holding lenders accountable for statutorily required submissions and started reviewing bank account transactions in fiscal year 2002, it did not conduct more detailed periodic monitoring of lenders. Its new processes did not include regular reviews of support for enrollment of loans and claims for defaulted loans. Also, there were no policies and procedures for monitoring and no standardized checklists for desk reviews and site visits. During our fieldwork, the Department began developing and implementing monitoring procedures and checklists. Improved monitoring would increase the reliability of reported results and would help ensure that funds are spent in accordance with applicable laws and regulations.

Recommendations

The Department should continue to develop and implement policies and procedures for periodic monitoring of lenders to:

- Hold them accountable for performance.
- Ensure the reliability and accuracy of forms submitted by lenders.
- Ensure compliance with laws and regulations.

Management's Response

The Department will continue to develop and implement policies and procedures for periodic monitoring of lenders. This monitoring will be to ensure the receipt of all required forms, the correct amount of interest, and the appropriate amount of reserves.

Deficiency checklists are now used to review the enrollment and claim forms submitted by lenders to ensure their completeness. A procedure was implemented to verify claims requiring lenders to submit loan default documentation prior to any withdrawals from the loan loss reserve. Additionally, data reported by lenders will be verified on a sample basis during site visits.

Training on the program's laws and regulations specifying eligibility and reporting requirements has been provided to the department staff. Training will be provided for all participating lenders on the eligibility, documentation, and reporting requirements of the Capital Access Program.

Defense Economic Adjustment Assistance Grant Program

The Department generally spent Defense Economic Adjustment Assistance Grant (DEAAG) funds in accordance with applicable laws and regulations. It did not ensure that reported program results were reliable. However, it held grantees accountable through contract provisions and monitoring. The Department spent \$7.4 million on grants in fiscal years 2001 and 2002.

Defense Economic Adjustment Assistance Grant Program

This program provides grants to adversely affected defense-dependent communities for projects such as purchasing property from the Department of Defense or its designated agent, rehabilitating or renovating facilities or infrastructure, and purchasing capital equipment.

Chapter 2-A

The Department Generally Spent DEAAG Funds in Accordance with Laws and Regulations

The Department generally spent DEAAG funds in accordance with laws and regulations. While our test of fiscal year 2001 and 2002 expenditures identified four expenditures totaling \$608,000 that were made after a regulatory deadline, the Department otherwise made these expenditures in compliance with laws and regulations. The Department made the final payments approximately 3 to 12 months after the deadline specified in Texas Administrative Code (Title 10, Part 5, Rule 174.2).

Recommendation

The Department should ensure that expenditures are made within regulatory guidelines.

Management's Response

The Department notes that the expenditures were consistent with state law and with the intended interpretation of the Department's regulation. The rule found at 10 TAC 174.2 restates Comptroller guidelines for permissible expenditures of grant funds and Government Code, Section 403.071(b), which provides that a claim may be paid if it is presented to the Comptroller for payment not later than two years after the end of the fiscal year for which the appropriation was made. According to the Comptroller's Office, an additional year was allowed to pay on the defense grants because the grant appropriation included the authority to carry unexpended balances forward from one fiscal year to the next within the biennium. The Department interpreted its rule accordingly. The Department will amend this rule to avoid the appearance of payments being made after the regulatory deadline.

The Department Did Not Ensure that Reported Results Are Reliable

The Department did not ensure that reported results for the DEAAG program are reliable. It reports the number of jobs created as a result of the grants given to defense-dependent communities. The Department compiles the number from semiannual reports it requires grantees to submit. However, the Department did not require grantees to provide supporting documentation, and it did not review supporting documentation during its monitoring visits. A review of supporting documentation of the jobs created is necessary to provide assurance that the program is achieving its goals. The purpose of the DEAAG program is to “increase employment opportunities for dislocated defense workers and residents of adversely affected defense dependent communities and reuse vacated property as efficiently as possible.”

Recommendation

The Department should review supporting documentation to ensure that reported program results are reliable.

Management’s Response

The Department concurs and once a year will require DEAAG grantees to provide payroll records for the jobs created in order to verify the reported number of jobs created is accurate. This data will be entered into a database and a sampling methodology will be established to examine source documentation of selected jobs to verify the job creation was a result of the DEAAG grant.

The Department Held DEAAG Grantees Accountable for Performance

The Department generally included provisions in DEAAG contracts and performed monitoring to hold grantees accountable.

The Department includes provisions in its contracts to hold grantees accountable for performance, such as:

- Specific statements of work.
- Close-out, cancellation, and termination clauses.
- Grantee reporting requirements.
- Clauses requiring grantee compliance with applicable laws and regulations.
- Performance metrics.
- Reimbursement for unallowable expenditures or for non-performance.

- Sanctions for poor performance or non-performance.
- Audit clauses.

However, we noted contracts that did not require the submission of federal reports required by the Texas Administrative Code (Title 10, Part 5, Rule 174.11) or define allowable and unallowable expenses. State agencies are required to adhere to Uniform Grant Management Standards when administering grants and other financial assistance agreements with cities, counties, and other political subdivisions of the State. Uniform Grant Management Standards specify the definitions of allowable expenses, as well as reporting requirements. Contract clauses requiring compliance with these standards would help grantees know what is required of them.

The Department performs periodic monitoring of grantee projects. This monitoring includes a site visit to confirm the progress of construction, review project documentation (such as architectural approvals, plans, and specifications), and to confirm project activities. However, as discussed in Chapter 2-B, it did not obtain or review supporting documentation for grantee assertions of the number of jobs created. Grant contracts specify a minimum number of jobs that must be created.

Recommendation

The Department should include a clause requiring compliance with Uniform Grant Management Standards in its grant contracts.

Management's Response

The contracts currently contain a clause requiring compliance with cost principles set out in OMB Circular No. A-87 - Cost Principles for State, Local, and Indian Tribal Governments. The Department will include a clause requiring compliance with Uniform Grant Management Standards in future contracts.

The Department generally spent Tourism contracting funds in accordance with contract terms and applicable laws and regulations. The Department's monitoring of the Tourism return on investment does not ensure that the return on investment is reliable. However, the Department generally held other Tourism contractors accountable for performance through contract provisions and monitoring. Total contracting expenditures were approximately \$33 million for fiscal years 2001 and 2002.

Tourism

The Department promotes Texas tourism by non-Texans. It accomplishes this through a variety of methods, including advertising both domestically and internationally and by conducting public relations campaigns.

Chapter 3-A

The Department's Monitoring Does Not Ensure the Reliability of the Return on Investment

Neither the Department nor its contractor performed regular or systematic monitoring to ensure that the return on investment calculation for fiscal year 2002 was reliable. Our tests identified that the current contractor used February data twice and did not use March data in its calculation of the return on investment for fiscal year 2002. The Department's monitoring did not identify this error. Return on investment measures the estimated state tax revenue generated by out-of-state leisure travelers to Texas for each dollar appropriated for tourism.

Return on Investment Methodology

A subcontractor conducted telephone surveys from a nationwide sample (excluding Hawaii and Alaska and other outlying parts of the United States) of adults age 25 and older. Then the contractor used the survey data to determine the proportion of respondents who took trips to Texas from out of state in the last 24 months, saw advertisements about Texas, and were influenced in their decision to come to Texas by the advertising, as well as the amount spent by those respondents as a result.

Based on this information, the contractor estimates the total spending on tourism resulting from tourism advertising, and from that figure it estimates the amount of state tax revenues generated. This estimated figure is divided by the Tourism budget to arrive at the tax revenues generated for the State of Texas for each dollar appropriated for tourism.

Texas cities and attractions may also advertise out of state. The survey asked respondents where they saw the Texas advertisement and what they remember about the advertisement. The Department asserts that it uses responses to these questions to exclude advertisements that were not produced by the Department.

In fiscal year 2002, the Department monitored the contractor by reviewing information the contractor submitted for reasonableness and consistency with historical trends. This is the same procedure the Department used to monitor a previous contractor that reported incorrect data for several years. According to the Department, the previous contractor reported results based on the data for a different state for several years. The Department discovered the problem when the return on investment declined from \$10.70 to \$7.70. When questioned, the contractor submitted a revised return on

investment of \$2.80. Although the Department replaced the contractor, it needs to perform additional monitoring to ensure that the data is reliable in the future.

Additionally, neither the Department nor the contractor performs regular and systematic monitoring of the administration of surveys by the subcontractor. Regular and systematic monitoring of the administration of surveys is important to ensure that the data the Department receives continually meets its needs and contract specifications.

Recommendation

The Department should ensure the reliability of the return on investment for tourism by incorporating additional procedures into its monitoring processes and/or requiring the primary contractor to perform additional procedures.

Management's Response

The Department will incorporate additional procedures into the monitoring processes of our Interagency Cooperation Contract (Contract) with the Texas Agricultural Experiment Station of the Texas A&M University System (A&M). The Department believes existing review processes provide for a statistically credible return on investment (ROI) estimate. The Department feels that this issue was probably not resolved due to a lack of effective communication between the Department, A&M, and SAO.

As stated in the auditor's report, the Department previously contracted with a private vendor to provide tourism ROI. However, the Department terminated this contact upon discovery that the contractor had reported an incorrect ROI. The incorrect ROI was due solely to a manual programming error the contractor made in developing a software program that the contractor needed to read and extract data from the contractor's survey database and then use that data to calculate and report the ROI. The Department could not have detected this error using its normal contract monitoring processes. Further, the Department did not have internal resources nor staff with sufficient technical expertise to detect such an error.

In 2001, primarily to address the previous problems with the ROI data, the Department entered into the Contract with A&M that included a requirement that A&M implement appropriate data management and analysis software technology to preclude the specific type of manual programming mistake made by the previous contractor. Additionally, the Contract includes performance requirements that mandate that A&M be responsible for conducting quality control of all its services. To meet this requirement, A&M uses a variety of quality control procedures to ensure data integrity. These checks include:

- *Regular reports that detail survey phone calls made;*
- *Comparing subcontractor's completed phone interviews to the monthly statement to ensure billings correspond to the number of survey phone calls made;*
- *Following up with survey respondents to validate the original survey;*

- *Daily monitoring of telephone survey calls to ensures proper surveying techniques; and*
- *Using multiple qualified research associates to cross-check and verify the calculation of the ROI.*

In addition to A&M's quality control checks, the Department staff also conducted its own contract monitoring activities, including:

- *Multiple contract monitoring visits and extensive ongoing communications with A&M to discuss and review contract performance issues, such as: survey methodology; survey instruments; identification and correction of errors; and compliance with contract performance requirements such as adherence to The Council of American Survey Research Organizations' Data Processing Guidelines; and*
- *Use of an annual contract Performance Review Report.*

Independent, third parties, including nationally recognized economist Ray Perryman, and the nationally recognized travel research firm of D. K. Shifflet and Associates, Ltd., have evaluated the methods used to calculate the tourism ROI. These parties have determined that the procedures used by A&M and its subcontractor exceed industry quality standards and produce results that are reliable and consistent with other measures for calculating a return on investment. These evaluations, on top of the effective quality control checks used by A&M and its subcontractor, along with the Department's own monitoring activities, form the basis for the Department's belief that the calculation of the ROI is reliable.

Auditor's Follow-Up Comment

The Department failed to provide evidence to support the processes described in its response while the audit team was collecting, testing, and analyzing information for this audit objective. We began collecting information on processes related to the return on investment in September 2002. We also discussed this finding with the Department on several occasions beginning in February 2003.

Although the Department did monitor the contractor using the Performance Review Report, this report does not indicate that the Department monitored the contractor to ensure that it performed quality control procedures as required by the contract. The Department is responsible for ensuring that the information it provides is reliable. If it chooses to rely on the quality control processes of a contractor, it should monitor the contractor to ensure that these processes are in place and effective. Without this assurance, there is a risk that further errors will occur and not be detected in a timely manner.

The Department Held Tourism Contractors Accountable

The Department's tourism contracts contained adequate provisions to hold contractors accountable. The Department performed monitoring to ensure that contractors complied with significant contract terms. However, additional monitoring would improve the reliability of reported results. Total appropriations for the Tourism strategy in fiscal year 2002 were \$19 million.

The Department holds contractors accountable for performance through its contracts by including clauses that specify:

- Statement of work.
- Definitions of allowable and unallowable expenditures.
- Methodologies for payment of contractor services and requirements that the contractor reimburse the Department for unallowable expenditures.
- Actions the Department can take if the contractor does not comply with the contract.
- How to terminate or close out the contract in an orderly and timely manner.

The Department also includes clauses required by the Texas Building and Procurement Commission and requires compliance with state and federal laws.

The Department monitors seven of the contracts annually using a Performance Review Report, which includes the significant responsibilities of each contractor. Additionally, the Department ensures that monthly reports from the public relations and Tourism representation contractors include the required elements, such as:

- Updates of completed projects and status.
- Logs of proactive trade contacts; proactive media contacts; and all consumer, media, and travel trade inquiries received and fulfilled during the prior month.
- Media clips for all media placements generated during the month.
- A report of all subcontracts awarded during the month.
- A report of the prior month's expenditures.

However, the Department did not retain the checklists used in monitoring a contractor that processes calls to the Department's toll-free telephone numbers. Additionally, the monitoring of the contractor that calculates the return on investment should be improved, as discussed in Chapter 3-A.

Even though the Department monitors its Tourism contractors and has policies and procedures for performing this monitoring, additional policies and procedures would help standardize the monitoring process. The Department's existing policies and procedures do not include:

- Procedures for on-site monitoring of the contractor.
- Guidance on how frequently program staff should perform monitoring.
- Guidance on tools, such as checklists, that are to be used and reports to prepare as part of the monitoring process.
- Follow-up steps to take, including possible sanctions, when the contract monitor identifies a performance problem.

Recommendations

The Department should:

- Retain documentation of monitoring for all contracts.
- Amend existing policies and procedures to address on-site monitoring, frequency of monitoring, monitoring tools, reporting, and actions taken upon identification of a problem.

Management's Response

The Department agrees, check lists and other documentation for monitoring of contracts should be retained and has already addressed the specific situation cited concerning the contract for processing calls to the toll-free telephone numbers. The Department will amend its existing policies and procedures to further address contract monitoring practices, including frequency, monitoring tools, reporting and follow-up actions to be taken upon identification of problems. Policies and procedures will be amended and become effective by July 1, 2003.

During our audit, we noted three information technology-related issues that the Department needs to address:

- The Department did not perform its year-end accounting close-out procedures for fiscal year 2001, resulting in unreliable financial account balances in its internal accounting system. For this reason, the Department had to use the Uniform Statewide Accounting System to prepare its fiscal year 2002 Annual Financial Report. The Department's internal accounting system should be the main source of information for budget analysis and financial data vital to management decisions. Due to the unreliability of financial account balances, the Department's accounting system may provide misleading information for analyzing budgets and making management decisions.
- The Department did not test its disaster recovery plan within the last year. Texas Administrative Code [Title 1, Part 10, Rule 202.6(a)(5)(E)] requires that the disaster recovery plan be tested annually. Testing is needed to ensure that the plan will work as intended and to identify areas in which the recovery plan should be improved. Testing also gives personnel a chance to become familiar with the recovery process, as it is not a normal part of operations.
- As discussed in Chapter 1-A, the Department's application controls over the Capital Access Database do not ensure that management has accurate and reliable data to make decisions. Because we noted weak controls, we tested the accuracy of the database. Although we did not find significant errors in the Capital Access Database for fiscal years 2001 and 2002, the Department's insufficient controls put the accuracy of future data at risk.

Recommendations

The Department should:

- Determine how best to close out its accounting system for prior fiscal years to ensure that data is reliable in the future.
- Test the key components of its disaster recovery plan annually as required by regulation.

Management's Response

The Department has determined how best to close the records to ensure reliability of data. The accounting records have been closed for fiscal year 2001.

In January 2003, the Department completely revised its disaster recovery plan. At that time, the requisite components of the plan were tested. These tests to the components of the disaster recovery plan will be performed at least annually.

Appendix

Objectives, Scope, and Methodology

Objectives

The audit objectives were to review contract and grant management and financial transactions of the Capital Access, Defense Dependent Communities, and Tourism programs at the Department of Economic Development (Department) to determine:

- Whether grantees and contractors are held accountable for performance.
- How program results are calculated and whether they are based on accurate and reliable data.
- Whether funds are spent in accordance with contract terms and applicable laws and regulations.

Scope

The scope of our audit included the Capital Access, Defense Economic Adjustment Assistance Grant (DEAAG), and Tourism programs. We tested expenditures made in fiscal years 2001 and 2002 related to contracts and agreements for the three programs. We reviewed reported program results in fiscal years 2001 and 2002 for the Capital Access and DEAAG programs and fiscal year 2002 program results for the Tourism program. We reviewed all contracts and monitoring files in the DEAAG and Capital Access programs, as well as major Tourism contracts for fiscal years 2001 and 2002. We reviewed application controls over the Capital Access Database and the Department's internal accounting system.

Methodology

Our methodology consisted of conducting interviews; collecting and reviewing information; and performing tests, procedures, and analyses against predetermined criteria.

We interviewed personnel from the Department and its contractors. We also contacted members of the advertising profession.

The information we collected and reviewed to accomplish our objectives included the Department's:

- Policies and procedures.
- Internal and external accounting systems and the Capital Access Database.
- Vouchers and supporting documentation.

- Contracts and related monitoring documentation.
- Reported program results and supporting documentation.

The procedures, tests, and analyses we performed included:

- Analyzing fiscal year 2001 and 2002 transactions to determine compliance with laws, regulations, and best business practices.
- Reviewing information underlying reported program results to determine whether the results are based on reliable data.
- Reviewing information from the Capital Access Database to determine whether it is accurate based on supporting documentation.
- Reviewing contracts and contract monitoring documentation to determine whether the Department's processes ensure accountability and ensure that funds are spent in compliance with laws, regulations, and contract terms.

Project Information

This audit was conducted in accordance with generally accepted government auditing standards. We conducted fieldwork from September 2002 through March 2003. The following members of the State Auditor's staff conducted the audit:

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