

Contract Administration at Selected Health and Human Services Agencies - Phase Three



Office of the State Auditor
Lawrence F. Alwin, CPA

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Key Points Of Report

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Overall Conclusion

Current contract administration practices at the Department of Human Services, Department of Protective and Regulatory Services, Department of Health, and Department of Mental Health and Mental Retardation do not consistently ensure that contractors use public funds prudently and in a manner which provides the most benefits to the citizens of Texas. Weaknesses in contract provisions, rate-setting methodologies, contract budget determination procedures, contractor selection processes, and agency oversight of contractors all increase the risk that public funds will be spent inappropriately. We identified over \$2.7 million in questionable expenditures during our review of 20 contractors who provide services for these four agencies.

Key Facts And Findings

- Service providers paid a *unit rate* are not held accountable for **how** they spend public funds. In total, 18 of the 20 providers reviewed had at least one unit-rate contract. Unit-rate contracts are structured such that once the contractor is paid the fixed rate for each unit of service delivered, there are no restrictions over the use of funds. As a result, the \$2.3 million identified in questionable expenditures are not violations of current contract provisions or agency regulations.
- Although provisions in *cost-reimbursement* contracts generally hold contractors accountable for how they spend public funds, most programs do not have an effective process for determining the reasonableness of cost reimbursement budgets. Inappropriate or inefficient uses of public funds were not consistently detected by the funding agencies during contractor audits. Thirteen of the 20 providers reviewed had at least one cost reimbursement contract, and we identified \$460,947 in questionable expenditures at these providers.
- In some instances, contractors receive compensation which exceeds the cost of providing services, as evidenced by expenditures which are inappropriate, excessive, or do not directly benefit the program. As a result, we concluded that the processes used to establish rates and contract budgets do not provide adequate assurance that the State is paying a fair and reasonable price for the services.
- Overall, there is a lack of central guidance or oversight of contract administration efforts, resulting in duplication of effort and a piecemeal approach on a statewide basis. Although multiple state agencies use the same contractor, agency regulations are inconsistent, and there is no coordination or communication among agencies regarding the contractors' performance.

Contact

Kay Wright Kotowski, CPA, Audit Manager (512) 479-4755



Office of the State Auditor

Lawrence F. Alwin, CPA

This audit was conducted in accordance with Government Code, § 321.05(a) and (b)(1).

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Executive Summary

Overall, the current level of fiscal oversight of purchased services does not consistently prevent or detect contractors' inappropriate or inefficient use of public funds. We identified over \$2.7 million in questionable expenditures during our review of 20 contractors who provide services for the Department of Human Services, Department of Protective and Regulatory Services, Department of Health, and Department of Mental Health and Mental Retardation. We found questionable expenditures at 18 of the 20 providers reviewed, with individual provider totals ranging from \$27 to \$1.6 million. The questionable expenditures included expenditures which were not reasonable and necessary for the operations of the programs, such as:

- excessive payments to related parties for management and consultant services
- purchase of land and blueprints for a church complex
- fund-raising costs which exceeded fund-raising proceeds
- excessive travel expenditures

The 20 contractors reviewed provided 35 different services to the citizens of Texas. These contractors play a valuable role by carrying out a significant portion of funding agencies' responsibilities. However, the agencies are ultimately accountable to the taxpayers for ensuring that public funds are used wisely and in a manner which provides the most benefit to citizens. The State paid over \$3.1 billion for these 35 types of services during fiscal year 1995.

Although a considerable amount of interest has been focused on the funding agencies' contract monitoring functions, *we found that agencies' ability to control contractor expenditures is limited by all of the following:*

- *Contract provisions and regulations are not sufficient to prevent inappropriate or inefficient use of taxpayer funds.*
- *Weaknesses in rate-setting methodologies, contract budget determination procedures, and contractor selection practices prevent the State from ensuring that contractors are paid reasonable and appropriate rates for providing services.*
- *Agency oversight of contractors does not adequately address fiscal or statewide accountability.*

In addition to the four agencies mentioned, prior State Auditor's Office reports have identified similar contract administration issues at the Texas Commission on Alcohol and Drug Abuse, Texas Rehabilitation Commission, Department on Aging, Texas Youth Commission, and Commission for the Blind. (See Appendix 2.)

Unit-Rate Contract Administration Does Not Prevent or Detect Inappropriate or Inefficient Use of Public Funds

Service providers paid by a *unit-rate* methodology are not held accountable for **how** they spend public funds. Although we identified over \$2.3 million in questionable expenditures at the service providers who use unit-rate contracts, *the majority of the expenditures are not violations of contract provisions or agency regulations.* The unit-rate contracts reviewed do not limit the contractor's use of public funds to the reasonable and necessary costs of service delivery. As long as quality services are delivered in accordance with the terms of the contract, providers can spend funds any way they choose without violating the terms of the contract.

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The risk that public funds will be used inappropriately or inefficiently is even greater if reimbursement rates paid by the agency exceed the contractors' reasonable costs of service delivery. We found that, *in some instances, contractors receive compensation which exceeds the costs of providing services*, as evidenced by expenditures which are inappropriate, excessive, or do not directly benefit the program objectives.

The rates for the majority of the unit-rate contracts reviewed were calculated based on cost report data submitted by the service providers. *Under this method of rate setting, all providers are paid the same rate for the same level of service, even if costs of service delivery differ.* As a result, if a contractor can reduce its expenses and still meet minimum standards, the facility can keep the difference between the rate paid and the cost of service delivery to spend as it chooses.

Weaknesses in Budget Determination and Fiscal Oversight Limit the Prevention and Detection of Inappropriate Expenditures for Cost-Reimbursement Contracts

Provisions in *cost-reimbursement* contracts themselves generally hold contractors accountable for how they spend public funds. However, agency evaluation of budgets proposed by service providers is not sufficient to prevent contractor compensation from exceeding the fair and reasonable costs of service delivery. Cost-reimbursement contracts compensate the contractor for the actual cost to provide services up to a maximum payment based on an approved budget. As these contracts provide little incentive to spend less than the maximum amount specified in the budget, in order to

prevent inappropriate use of public funds, it is essential that the approved budget reflects fair and reasonable compensation. Thirteen of the 20 providers reviewed had at least one cost-reimbursement contract, and we identified \$460,947 in questionable expenditures at these providers.

Once contract budgets are approved, auditing of contractor expenditures is the only way to ensure that funds are spent in accordance with the terms of the contract. While most of the programs had established fiscal monitoring functions, we identified weaknesses at some agencies which limit the detection of inefficient or inappropriate use of public funds.

The Majority of Health and Human Services Contractors Are Not Selected Using Competitive Procurement Processes

Traditional competitive procurement procedures were not used to award the majority of the contracts reviewed. Competition helps ensure that the State is receiving the highest quality services at the most cost-efficient prices.

For many programs, contractors are selected through an enrollment method. This method is mandated by the Federal Government in some cases. As a result, funding agencies are not given an opportunity to select the most qualified and efficient contractor, but must use those contractors who can meet the enrollment requirements.

For those funding agencies that do use a competitive procurement method, we found weaknesses which prevent the agencies from

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ensuring that the best contractor is objectively selected.

There Is a Lack of Central Guidance or Oversight of Contract Administration Efforts Which Results in Duplication of Effort and a Piecemeal Approach on a Statewide Basis

Statutes and policies governing the use of public funds vary significantly among state agencies and even between programs within agencies. These inconsistencies contribute to the inadequacies in the contract provisions.

The only uniform state-mandated standards for contract and grant administration are the Texas Uniform Grant and Contract Management Standards (UGCMS). In accordance with state regulations, UGCMS adopts contract and grant management standards established by the Federal Government and applies them to grants and contracts made with state funds, *but only applies them to grants and contracts with other state and local governments*. As a result, there are no uniform standards which apply to non-profit or for-profit organizations' use of public funds.

Although multiple agencies often use the same contractor, there is no coordination or communication between agencies regarding the contractor's performance. Each agency representative monitors for its own particular compliance issues, which results in failure to see the "big picture." During our review of contractors, we noted that the 20 service providers had been monitored at least 63 times combined by the funding agencies during fiscal years 1994 and 1995.

Summary of Management's Responses

Management's responses from all four agencies, as well as from the Health and Human Services Commission, are included immediately following Section 9 of this report.

Objective, Scope, and Methodology

The primary objective of this project was to identify instances of fraud, waste, or abuse of taxpayer funds and to determine specific systemic weaknesses at the four agencies included in this audit which would allow such instances to occur. To accomplish this, we audited the:

- accounting records of 20 service providers to assess their use of state funds
- contractor selection process to determine if the process used by the agency provides reasonable assurance that the best contractor is objectively selected
- rate-setting methodology used to develop the contracted rate in order to determine if the rates fairly reflect the cost to provide services

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Overall Assessment

Overall, there is a lack of central guidance and oversight of contract administration on a statewide basis. Work completed by the State Auditor's Office at 11 state agencies has identified pervasive problems in contract administration which limit the State's ability to protect public funds from fraud, waste, or inefficient use by contractors. (See Figure 2 on page 8.) To further determine whether public funds are used properly and efficiently at the provider level, we expanded our contract administration work at the four largest health and human services agencies¹ (Department of Human Services, Department of Protective and Regulatory Services, Department of Health, and Department of Mental Health and Mental Retardation) to include audits of service providers (referred to in this report as "HHS service providers").

Contractors play a valuable role for the State by carrying out a significant portion of funding agencies' responsibilities. However, the funding agencies ultimately have an obligation to ensure that public funds are used wisely and in a manner which provides the most benefits to the citizens of Texas. In order to do so, it is essential that agencies have contract administration systems which ensure that the State is paying the best price to the most effective and efficient contractors.

Statutes and policies governing the use of public funds vary significantly among state agencies and even between programs within agencies. Although this makes it difficult to generalize, we identified several systemic issues which prevent the State from ensuring that funds are spent appropriately and efficiently.

- **Contract administration regulations are not sufficient to prevent inappropriate or inefficient use of taxpayer funds.** The majority of the contracts we reviewed do not restrict actual contractor expenditures to the reasonable and necessary costs of providing the services. *Most of the contracts did not contain provisions specifying allowable and unallowable expenditures, or which require the contractor to reimburse the funding agency for inappropriate expenditures.* As a result, there are no restrictions to prevent contractors from using public funds inappropriately. The generous nature of these contracts allow providers to make questionable expenditures which might otherwise be considered fraud.
- **Weaknesses in rate-setting methodologies, contract budget determination procedures, and contractor selection practices prevent the State from ensuring that contractors are paid reasonable and appropriate rates for providing services.** Rate-setting methodologies and contract budget determination procedures used to establish payments for contracts do not ensure that the State is paying the best price for the services purchased. As competitive procurement procedures are not used to award the majority of the contracts reviewed, reimbursement amounts are not based on market forces.

¹In terms of expenditures for purchased services.

- **Agency oversight of contractors does not focus on fiscal or statewide accountability.** Most monitoring performed by the funding agencies is focused on program compliance. In addition, agency monitors concentrate on their agency's funding sources only, not on the statewide accountability of service providers who receive funds from multiple funding sources.

Although the issues identified in this report primarily relate to the fiscal accountability of service providers, *it is equally important that agency oversight of contractor performance ensures that citizens consistently receive quality services.* Contract administration issues pertaining to the quality of services provided by contractors have been addressed in previous State Auditor's Office audit reports. (See Appendix 2.)

The degree to which each of the systemic issues identified above affects the ultimate cost of the contract is primarily dictated by the method of contracting. (See Figure 1 for descriptions of contract methods.) For example, unit-rate contracts reimburse the contractor a flat rate for each unit of service delivered. These contracts are structured such that as long as the contractor delivers the specified units of service for the specified rate, there are no restrictions over the subsequent use of funds. If the established rate exceeds the contractor's cost to provide services, the contractor is provided with "excess" funds to spend as it chooses without violating the terms of the contract. This increases the risk that public funds will be used inappropriately or inefficiently.

On the other hand, cost-reimbursement contracts generally contain explicit financial reporting and monitoring requirements. Cost-reimbursement contracts reimburse the provider for the actual costs of providing services, which are usually based on budgets submitted to the funding agency prior to the contract award. As there is little incentive for the providers to spend less than the maximum specified in the contracts, it is essential that the final budget reflect a fair and reasonable price for the services purchased. In addition, the provider's expenditures must also be audited in order to verify that funds were spent in accordance with the terms of the contract.

Our review of statewide contracting practices led us to the conclusion that there is not one "right" way of contracting, and we do not advocate standardization of one method of contracting for every service. Rather, we recommend that an effective system of contract administration should be sufficient to ensure that public funds are used appropriately and efficiently regardless of the method of contracting. In order to do so, agencies should have a process that ensures a reasonable correlation between the cost of service delivery and contractor compensation, irrespective of whether a cost-reimbursement contract or a unit-rate contract is used.

Figure 1

Differences Between Unit-Rate and Cost-Reimbursement Contracts Reviewed

Control Area	Unit-Rate Contracts	Cost-Reimbursement Contracts
Structure of Contract Provisions	<ul style="list-style-type: none"> • Contractors are reimbursed a fixed rate for each unit of service delivered. • Contracts do not contain provisions which limit actual expenditures to the reasonable and necessary costs of providing services (by specifying uses of funds) or require the contractor to reimburse the funding agency for any inappropriate expenditures. 	<ul style="list-style-type: none"> • Contractors are reimbursed for actual costs of providing services, up to a maximum specified in the contract. • Contracts require funds to be spent in accordance with approved budget. Contract provisions specify allowable and unallowable uses of funds, and require reimbursement of funds used inappropriately.
Establishment of Reimbursement Amounts	<p>Fixed rate is established using one of these methods:</p> <ul style="list-style-type: none"> • Analysis of cost information submitted by provider • Based on factors other than cost such as prevailing Medicaid rates (fee-for-service) • Competitive negotiation 	<p>Reimbursement amount is based on analysis of contractor's proposed budget during contractor selection or renewal process.</p>
Agency Oversight	<p>Focuses on the delivery of quality services, not the appropriateness of contractor expenditures.</p> <p>As the contracts do not restrict contractor expenditures or require reimbursement of funds used inappropriately, questioned costs identified through fiscal monitoring would not result in recoupment of these funds.</p>	<p>Fiscal oversight focuses on verifying that expenditures were:</p> <ul style="list-style-type: none"> • Allowable based on guidelines included in the contract • Reasonable and necessary for the operation of the program • In accordance with approved budget <p>Expenditures which do not meet this criteria must be reimbursed to the funding agency.</p>

Figure 2
Agencies Covered by SAO Contract Administration Projects

Agency	Fiscal Year 1995 Purchased Services Expenditures *
Department of Health	\$ 5,655,752,492
Department of Human Services	2,818,581,715
Department of Mental Health and Mental Retardation	410,262,949
Department of Protective and Regulatory Services	255,427,633
Texas Commission on Alcohol and Drug Abuse	155,354,195
Texas Rehabilitation Commission	121,747,492
Texas Department on Aging	57,200,355
Interagency Council on Early Childhood Intervention	28,665,365
Texas Youth Commission	19,628,487
Texas Commission for the Blind	15,776,768
Texas Cancer Council	342,724

* Source: USAS expenditures for selected object codes.

Note: The total listed for the Department of Health includes payments to Medicaid contractors, which were not included in this audit.

Sections 1 through 5 of this report are a comprehensive overview of the contract administration issues facing the State, supported by examples from both the recent review of HHS service providers and our prior work at the other agencies. Sections 6 through 9 provide specific agency information related to our most recent work at the Department of Human Services, Department of Protective and Regulatory Services, Department of Health, and Department of Mental Health and Mental Retardation.

Section 1:

Unit-Rate Contract Administration Does Not Prevent or Detect Inappropriate or Inefficient Use of Public Funds

Service providers paid by a unit-rate methodology are not held accountable for *how* they spend public funds. In total, 18 of the 20 HHS service providers reviewed had at least one unit-rate contract and received over \$61 million from the State during the period audited. In addition, the Texas Youth Commission and Texas Rehabilitation Commission spent over \$141.3 million during fiscal year 1995 using the unit-rate method of reimbursement. These contracts are structured such that once the contractor is paid the fixed rate for each unit of service delivered, there are no restrictions over the use of public funds. As a result, the funding agencies, for the most part, do not think it is necessary to audit or review contractor financial operations to determine if resources are spent appropriately or efficiently. The funding agencies are primarily concerned that quality services have been delivered, not with how funds are actually spent.

Unit-rate contract provisions and associated agency regulations allow funds in excess of the reasonable costs of service delivery to be spent any way the providers choose without violating the terms of the contract. (As some of the contractors are for-profit organizations, a profit margin is inherent in the notion of "reasonable and necessary costs.") During our review of HHS service providers paid through unit-rate contracts, we found that contractors had spent over \$2.3 million of "excess" public funds on questionable items such as payments of excessive fees to related parties, entertainment, gifts, and excessive travel costs. In our previous work at the Texas Youth Commission and the Texas Rehabilitation Commission, we found similar types of questionable expenditures.

While the underlying premise of the unit-rate reimbursement methodology is valid, the availability of "excess" funds for providers to use on excessive or questionable expenditures indicates that, in some cases, providers are paid more than the reasonable and necessary costs of providing services. We found numerous weaknesses in the rate-setting methods which prevent the funding agencies from ensuring that the contractor is compensated at a fair and reasonable rate for the services delivered.

Section 1-A:

Unit-Rate Contractors' Expenditures Are Not Limited to the Reasonable and Necessary Costs of Providing Services

Although we identified over \$2.3 million in questionable expenditures at the HHS service providers who are paid through unit-rate contracts, the majority of the expenditures are not violations of current contract provisions or agency regulations as currently written. Of the 32 unit-rate contracts reviewed, only one included provisions which limit contractor expenditures to the reasonable cost of providing services and required the contractor to reimburse the funding agency if questionable expenditures are made. [The Women, Infants, and Children's (WIC) program administered by the Department of Health reimburses actual costs up to a maximum amount calculated

using predetermined unit rates. See Section 8 for additional details.] As a result, the contractors are not obligated to refund the \$2.3 million to the funding agencies.

In contrast, the unit-rate contracts used by the Texas Commission on Alcohol and Drug Abuse (TCADA) during fiscal year 1995 contain provisions which limit contractor expenditures to the lower of the rate paid or the cost of providing services and restrict contractor expenditures in accordance with the appropriate federal cost principles. These provisions allow TCADA to seek reimbursement of inappropriate or unallowable expenditures made by service providers.

In our previous work, we found that neither the Texas Youth Commission's nor the majority of the Texas Rehabilitation Commission's contracts contained provisions which limited contractor expenditures to the reasonable and necessary costs of doing business. In fact, the Texas Rehabilitation Commission had only developed formal contracts for \$2 million of the \$121 million spent on purchased client services.

In some cases, unit-rate contracts contain provisions which require the contractor to submit an annual cost report to be used in establishing rates. In these cases, agency regulations and cost report instructions require the contractor to exclude unallowable costs from reported expenditures in an attempt to ensure that the rate is only based on the reasonable and necessary costs of providing the services. However, cost report requirements only limit the expenditures which can be included on the cost report; they do not limit how public funds can actually be spent. As a result, *contractors are still allowed to spend public funds on items that may otherwise be considered inappropriate* as long as these costs are not included on their cost report. The following examples illustrate this point:

- At one provider of residential services for the Department of Protective and Regulatory Services (DPRS), we found that the provider purchased the home of the executive director and her husband and converted this home to a campus. The purchase price of \$417,000 appears to be excessive as the home is located in a small, rural town. Two of the three market comparisons used to support the selling price were from homes located in a large urban city. The provider challenged our basis for questioning these expenditures, stating that since the gain realized by the executive director is not included on the cost report submitted to DPRS, the State is not funding the purchase. However, because this provider receives 96 percent of its funding from DPRS, state funds were clearly used.
- At one provider of primary home care services for the Department of Human Services (DHS), we found that the provider spent \$104,536 for a computer lease to a company owned by the provider's president. For cost report purposes, the cost of the lease must be reduced to the price paid by the related party. In this case, the related party's cost for the computers was only \$34,156, which was appropriately included in the cost report. However, the provider actually spent \$104,536 (\$70,380 over the actual cost) for the use of the computers. This provider receives over 89 percent of its funding from DHS.

The funding agency does not have the ability to recover the questioned costs in either of these situations because the contract does not prohibit such expenditures.

Section 1-B:

Rate-Setting Methodologies Have Resulted in Contract Compensation Which Can Exceed the Cost to Provide Services

In addition to inadequacies in contract provisions, we found that the rate-setting methodologies used to establish reimbursement rates for unit-rate contracts do not consistently ensure that the contractor is compensated only for the reasonable and necessary costs (which includes a profit margin for the for-profit contractors) to provide services. Because contract provisions and associated agency regulations allow providers to spend any excess of the rate received over the costs of service delivery as they choose without violating the terms of the contract, it is critical that reimbursement rates reflect only the reasonable and appropriate costs of providing services, or that the contract should limit the contractors' payments to the lower of the rate paid or the costs incurred to provide services.

The most striking example of the use of "excess" funds we found was at the provider of residential services for DPRS (which was previously mentioned). This provider engaged in numerous questionable transactions totaling over \$1.6 million. These examples of questionable expenditures include the following:

- The provider assumed the executive director's loan for 26.54 acres of land and for four mobile homes.
- The executive director uses her home as an additional campus for the provider and owes the provider \$58,903 for advances made to herself (for the campus at her home).
- The provider purchased blueprints, surveys, and plans for a \$5 million church complex it intends to build.
- The provider purchased and improved (at a total cost of \$196,357) a house which is used for the executive director's office and other administrative purposes.

As this provider is a non-profit organization, the fact that funds were available for use on these expenditures clearly indicates that the provider was receiving more than the "reasonable and necessary costs of providing the services." Other examples include:

- One nursing home contractor made either inappropriate or unsupported expenditures of \$267,292. Examples included payment of management and consulting fees (some of it to related parties), travel expenses, advertising expenses, and other administrative expenses for which there was no documentation to support that the expenditures were related to the objectives of the program.

- One primary home care provider leased computers from a company owned by the provider's president and vice president. The provider leased computers at an average cost of \$432 a month, resulting in an average annual rental cost of \$5,184 per computer (based on the invoices reviewed). For the contract year reviewed, the provider paid \$104,536 to the related party company for the computer leases, resulting in a \$70,380 profit on the transaction. In addition, the same president and vice president own the building which the provider leases and recognized a profit on the lease of \$14,386. (This provider received 89 percent of its funding from DHS.)

Reimbursement rates for the providers reviewed were established by one of three methods:

- Rates for 47 percent of the contracts included in our sample were developed using a **common cost-finding methodology** established by the funding agencies. The rates are based on allowable costs included in cost reports submitted by service providers. We found that controls over the information submitted on the cost reports were minimal and, as a result, question the accuracy of the data used to establish the rates.
- **Fee-for-service** types of contracts present completely different problems. These rates are based on factors other than cost, such as the prevailing Medicaid rates or market studies. As these rates are not established based on the costs to provide services, it is difficult to evaluate the reasonableness of the rates based on the costs incurred by the service provider.
- Two programs used **competitive negotiation** to establish rates on a provider-by-provider basis. Although this method allows rates to be tailored to meet the needs of each location, the appropriateness of the negotiated rate is dependent on the skills and knowledge of each negotiator. In order to negotiate fair and reasonable prices, negotiators need training and a thorough knowledge of the industry.

The processes used to establish the rates and their associated strengths and weaknesses are discussed in detail below.

When rates are based on cost report data, providers are paid the same rate for the same level of services, regardless of the actual costs of providing the services. The methodology used to establish rates based on the analysis of costs reported by service providers inherently results in some providers receiving compensation which exceeds the reasonable and necessary costs of providing services. The unit rate is calculated using the median cost (with medians being used in different cost centers) of all providers of a particular service plus a markup factor which varies from program to program. The median-based methodologies are designed to produce a rate which will cover the cost to provide services for more than half of the providers. However, none of the providers reviewed were paid less than their costs of providing services.

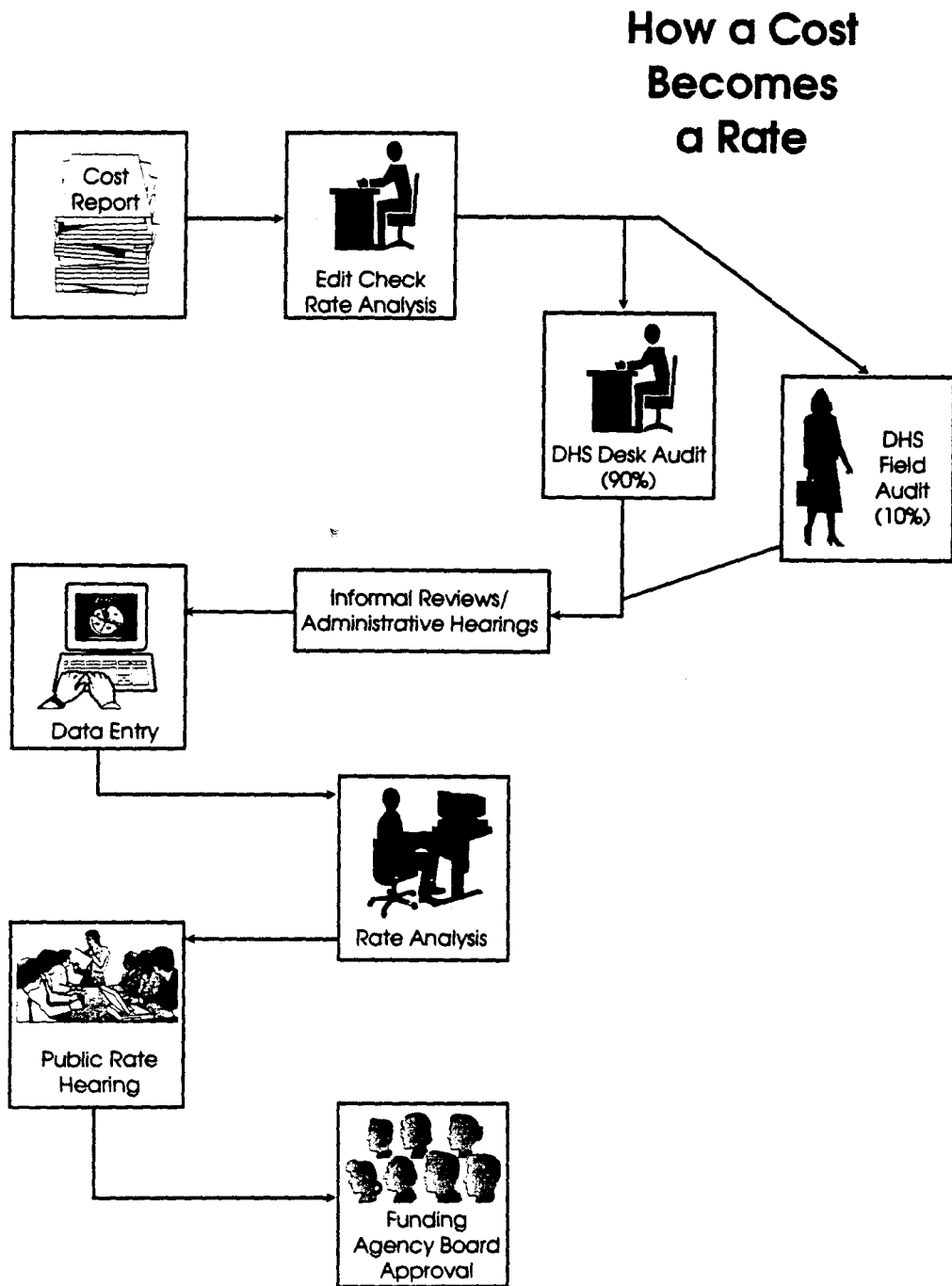
Under this method of rate-setting, all providers are paid the same rate for the same level of services, even if costs differ. Variations in costs of doing business in different parts of the State are not taken into consideration, nor are differences between for-profit and non-profit providers considered. Since the rates are based on median costs, if a contractor can reduce its expenses and still meet minimum standards, the facility can keep the difference between the rate paid and the costs incurred to spend as it chooses. Thus, it appears that the providers with the highest profits are the providers who could most easily reduce costs. As a result, it is less profitable for the providers to incur additional costs to increase the quality of services, because whether they are non-profit or for-profit organizations, their "profit" would decrease.

Figure 3
Programs Which Base Rates on Cost Report Data

Program	Funding Agency
Residential Treatment Centers	Department of Protective and Regulatory Services
Child Placing Agencies	Department of Protective and Regulatory Services
Nursing Facility	Department of Human Services
Primary Home Care	Department of Human Services
Community Living Assistance (Includes Family Care)	Department of Human Services
Intermediate Care Facilities for the Mentally Retarded	Department of Mental Health and Mental Retardation
Home and Community Based Services	Department of Mental Health and Mental Retardation

Seven of the programs we reviewed used rates established using this method. (See Figure 3.) The rates are established using cost report data submitted annually by the contractors. DHS performs the rate-setting tasks such as rate analysis and desk and field audits for its own programs, as well as on behalf of other agencies through interagency agreements. However, the governing board of each funding agency is responsible for approving the rates calculated by DHS. For residential services, these rates must not exceed maximum rates set by the Health and Human Services Commission.

Figure 4
 Rate Setting Process for Unit Rates Based on Cost Report Data



As illustrated in Figure 4, the rate-setting process itself is well-defined and includes edit checks, data analysis, audits of cost reports, informal reviews, and public hearings. In addition, DHS has recently proposed revisions to the Texas Administrative Code which are designed to build more accountability into the cost report rules by strengthening cost determination requirements. However, we noted the following inherent weaknesses in the process:

- **There is little assurance that information used to calculate reimbursement rates is accurate.** Because the information included on the cost report is used to calculate the reimbursement rates, it is essential that the cost reports be accurate. For the most part, the funding agencies place a high degree of reliance on the accuracy of the information provided by the contractor. The following weaknesses cause concerns over the accuracy of the information included on the cost report:
 - Only 10 to 15 percent of the cost reports for each program receive field audits annually. Audits are necessary in order to ensure the accuracy of the cost report data. For example, in the case of the Nursing Facility Program, which has approximately 1,100 providers, with ten percent coverage, each provider will be audited on average only once every ten years. Although all remaining cost reports receive a desk review, these reviews are limited in scope and are not comparable to an actual audit of the financial information.

For example, in our field audit at a nursing home provider, we found approximately \$260,000 in questionable costs which should not have been included in the fiscal year 1994 cost report. The questionable expenditures included management and consulting fees paid to the owners (in addition to their regular salaries) totaling \$132,000. The providers could not provide any documentation that the owners had actually provided services to the nursing home for these payments.

The Department performed a desk review of this audit and made adjustments to remove the \$132,000 in management fees because they had also been reported in overhead expenses and \$100,903 in building lease expense to reduce the amount paid to a related party. Thus, while the desk review resulted in an appropriate reduction of the provider's reported costs, the \$260,000 in questionable expenditures identified during the course of our field audit was still included in the data base used to calculate the rates.

- There are no serious consequences for filing inaccurate cost reports. If unallowable expenditures are discovered in the audit of a cost, the provider is not required to reimburse the funding agency. The service provider is given notice of what needs to be corrected and required to remove the expenditures from the cost report so they are not used to calculate the rates.

Chapter 40 of the Texas Administrative Code does allow DHS to place a hold on vendor payments for such things as submitting an unauditible cost report, filing a late cost report, or failing to give access to field auditors. The current

rules for the community-based programs allow the contractor 90 days to bring records into compliance or DHS will withhold payments. However, DHS has proposed rules which will decrease the time to 30 days.

There have been no instances of prosecution for fraud. According to DHS, the Office of the Attorney General will not prosecute cases related to inaccurate cost reports. The rate-setting methodology results in only the median cost report of a specific provider being used to set rates. Therefore, unless a provider knew that its cost report would be the median cost report, and also knowingly submitted inaccurate cost reports with the intent of affecting the rate, there is no basis for prosecution.

- Currently, it is not mandatory that providers attend training on cost report preparation. The providers receive explicit instructions for preparing the cost report and notification of training classes, but providers are not required to attend. DHS has proposed rules which will make cost report training mandatory for all contractors.
- There are no standards for computing costs such as administrative expenses. Without defining standards for certain costs, DHS cannot compare costs between providers and evaluate efficiency. For example, our analysis of fiscal year 1993 cost report data for the Nursing Facility Program found that total administrative expenses ranged from 74 percent of total expenses to two percent of total expenses. For the Primary Home Care Program, total administrative expenses ranged from 56 percent to five percent of total expenses. This wide variation appears to indicate that some providers are more efficient than others, but without established standards or definitions of administrative expenses, a true comparison cannot be made.

DHS has set caps for the reporting of compensation of owners, partners, and stockholders for the Nursing Facility Program, but not for any of the Department's other programs. Under this cap, the total compensation which is figured into the rate-setting base is limited to \$55,568 for the administrative salaries and wages of an owner, partner, or stockholder. This provides some assurances that excessive salaries are not included in the data used to calculate the rates, but it still does not preclude the provider from paying higher salaries.

- There is a lack of accounting experience at the provider level. Eleven of the 20 providers reviewed were required to prepare at least one cost report to be used in establishing reimbursement rates. During our review of the 11 providers who were required to submit cost reports, we found that:
 - * Six of the 11 had experienced recent turnover in key accounting positions. In several cases, the new personnel had difficulty in explaining how they accounted for public funds.

- * Three of the 11 providers did not have documented accounting policies and procedures.
- * Five of the 11 providers did not allocate expenditures by individual funding sources. When costs are incorrectly allocated to state funding sources, the expenditures included on the cost report could be inflated.
- **The Health and Human Services Commission is not actively involved in the rate-setting process.** Although the Health and Human Services Commission is responsible for recommending ceiling rates for residential services, the Commission is not actively involved in the rate-setting process. Rider 17, Article II of the General Appropriations Act specifies that no appropriated funds for residential services shall be expended unless the rates do not exceed the maximum amount for each level of care recommended by the Commission. Although this implies that the Commission is responsible for setting maximum rates, its statutory role in the rate-setting process is not clear.

Currently, the health and human services agencies send their Medicaid rates to the Commission, and the Commission approves them. Although the Commission did set maximum rates in 1993, these rates just served as recommendations since the Commission does not have enforcement power to ensure that agencies adhere to the rate ceilings. Due to a recent reduction in force, all of the staff who previously worked in the area of rate setting are no longer with the Commission. As a result, the Commission is in the process of redefining its role in the rate-setting process.

During our review, we analyzed fiscal year 1993 cost report data submitted for the Primary Home Care Program of DHS. Our analysis indicated that a number of providers received an excess of funds from DHS over and above their total expenses. Further analysis indicated that the highest "profits" (although some of these providers were non-profit organizations) were achieved by those programs which had the highest number of service hours. This indicates that contractors who provide services in high volume receive the highest profit since once they have covered their fixed costs at a certain level of service, the profit margin is higher on the remaining hours of services.

Based on a practice used in the private sector, where bulk purchases are usually discounted, we developed a hypothetical reimbursement model which would provide DHS with a "discount" for "bulk" purchases of services. Under this model, we assumed that for hours of service in excess of 500,000, the provider would only be reimbursed 90 percent of the regular flat rate. Application of this model affected 17 of the Primary Home Care providers (i.e., those who had over 500,000 hours of service in fiscal year 1993). Based on the results of our application, *the Department would recognize a savings of \$5.5 million annually.*

Although this hypothetical model is simple and not based on a statistical methodology, it indicates that minimal adjustments to the rates could result in considerable savings to the State. The profit margin for the 17 providers affected by the discounted rate still ranged from .6 to 17 percent after the application of the discounted rate. As the

providers are still earning money with each additional hour, there is no disincentive to stop providing services over the discounted level. In addition, the level of hours and the amount of the discounted rate can easily be changed to arrive at an agreeable rate for all parties.

Alternative methods of rate-setting also have weaknesses. Several of the contracts we reviewed used methods other than the cost report method to establish rates.

- The Title XX Home Delivered Meals Program at DHS uses competitive negotiation to establish rates. Although this method allows rates to be tailored to meet the needs of each location, the accuracy of the negotiated rates depends upon the skills and knowledge of the agency's regional negotiators. As DHS has not prepared written policies and procedures to assist regional contract managers in negotiating the rates, variation in rates may be based on negotiator skills rather than on true differences in costs to provide services.
- Rates for Maternal and Child Health (Title V) and Family Planning Services (Title XX) at the Texas Department of Health (TDH) are based on Medicaid rates. However, in some cases, TDH has developed its own rates for services which are not included in the Medicaid rates. For example, since Medicaid does not allow for outreach and case management services, the Title V rates for procedures which include these services have been increased by 50 percent for prenatal and child health visits. These increases are not based on analysis of the costs to provide these services, but have been subjectively determined. As a result, it is difficult to assess the appropriateness of the rates.

Weaknesses in rate-setting methodologies have been previously identified by the State Auditor's Office, yet these weaknesses remain uncorrected at DHS and DPRS. In two previous reports, *A Review of Management Controls at the Texas Department of Protective and Regulatory Services* (SAO Report No. 95-003, September 1994) and *Program Audit of Long-Term Care Services to the Aged and Disabled at the Department of Human Services* (SAO Report No. 92-120, May 1992), the State Auditor's Office identified many of the same weaknesses in the rate-setting methodologies as those identified above. Our follow-up on the recommendations contained in these reports indicated that, for the most part, the official rate-setting processes at DHS and DPRS remain unchanged.

In addition, recent State Auditor's Office reports on the Texas Youth Commission (TYC), Texas Rehabilitation Commission (TRC), and Texas Department on Aging (TDoA) identified the following weaknesses in rate setting:

- During our review of TYC, we found several indications that the cost to provide the services was less than the rate paid by TYC. TYC does not have a formalized rate-setting process. TYC primarily relies on "market forces" and on past experience with a provider to negotiate rates with contractors and uses the Health and Human Services Commission's rate ceilings to provide a reasonableness check on negotiated rates. However, we noted significant weaknesses in the

methodology used to establish the ceiling rates (SAO Report No. 96-005, September 1995).

- At TRC, we found that the agency does not have a formalized, cost-based, rate-setting methodology or a process to ensure that rates are cost effective. TRC currently uses a fee-for-service structure. As a result, TRC has no assurance that reimbursements to providers correlate with costs and reflect only appropriate and reasonable costs related to providing services (SAO Report No. 96-012, October 1995).
- At TDoA, we found that the rates developed by the agency are not aligned with the actual cash cost to provide services. Volunteer and in-kind contributions are given a value and included in the rates paid to Area Agencies on Aging (AAAs), clouding the true cash cost of providing services. Changes to the current rate-setting processes could improve accountability by making rates comparable among AAAs and with the contracted rates providers have with other agencies (SAO Report No. 96-030, December 1995).

We have not yet performed a follow-up audit to determine if improvements in the rate-setting processes have been made as these reports have all been issued within the last six months (since September 1995).

Section 2:

Weaknesses in Budget Determination and Fiscal Oversight Limit the Prevention and Detection of Inappropriate Expenditures for Cost-Reimbursement Contracts

Although provisions in cost-reimbursement contracts generally hold providers accountable for how they spend public funds, weaknesses in agencies' reviews of contract budgets may result in maximum contract amounts which exceed the amount truly necessary to provide services. Cost-reimbursement contracts reimburse the contractor for the actual costs to provide the services and generally contain very specific provisions regarding goods and services on which the contractor is allowed to spend funds. The contract limits total expenditures by specifying a maximum payment, which is usually based on a budget submitted by the contractor prior to the award.

We found that many of the programs using this type of contract did not have a sufficient process to review and evaluate the provider budget. One weakness of cost-reimbursement contracts is that there is usually little incentive to spend less than the maximum specified in the contract. As a result, it is essential that the proposed budget be carefully evaluated during the contractor selection process in order to ensure that the final approved budget reflects a fair and reasonable rate for the purchased services.

While most of the programs had established fiscal monitoring functions, we identified weaknesses at some agencies which limit the detection of inefficient and inappropriate uses of public funds. Thirteen of the 20 providers reviewed had at least one cost-reimbursement contract, and we identified \$460,947 in questionable expenditures at these providers.

Section 2-A:

Most Cost-Reimbursement Contracts Contain Adequate Provisions to Hold the Contractor Accountable

Many of the cost-reimbursement contracts reviewed contained explicit financial reporting and monitoring requirements. However, cost-reimbursement contracts for the programs reviewed at DPRS did not include provisions which clearly specify allowable and unallowable costs or contractor financial reporting requirements.

Providers who are reimbursed on a cost-reimbursement basis are required to submit detailed budgets prior to the contract award and budget justifications each year based on their anticipated costs to provide the services. The contracts contain provisions which limit the contractors' expenditures to those included in the approved budget.

For example, TDH's cost-reimbursement contracts contain the following requirements:

- Provider must submit routine financial reports (monthly or quarterly).
- Contractors receiving \$25,000 or more in total federal/state financial assistance must obtain an independent financial and compliance audit.
- Contract expenditures must comply with federal cost principles for allowability.
- Providers must refund any funds claimed and received which TDH determines to be ineligible for reimbursement.
- Providers must develop, implement, and maintain financial management and control systems that meet or exceed the requirements stipulated by the Uniform Grants and Contract Management Act.

We also noted that the cost-reimbursement contracts used by the Texas Cancer Council and the Child Care Management Services (CCMS) program administered by DHS contained very specific provisions which limited certain expenditures such as travel to the same amounts as those approved for use by state employees.

Section 2-B:

Most Programs Have Not Established an Effective Process for Determining the Reasonableness of Cost-Reimbursement Budgets

Reimbursement amounts for most of the cost-reimbursement contracts reviewed are established based on informal reviews of budgets submitted by the service providers. As these budgets form the basis for contractor payments, there is little incentive for providers to spend less than the amount approved by the funding agencies. As a result,

a comprehensive analysis of the budget is critical to ensure that the State pays a fair and reasonable price for the services purchased.

The following examples highlight the weaknesses found in the budget evaluation procedures used by the various programs:

- The HIV/AIDS Program administered by TDH reviews proposed budgets for reasonableness based on experience with other providers. However, TDH does not maintain any documentation that identifies the costs to provide services. *During our review of provider's proposed budgets, we noted three instances in which contractors received more funding than requested in their proposed budget.*
- Although TDH reviews budgets submitted by Title X (Family Planning) program for reasonableness, there are no written guidelines on what constitutes reasonableness. In reality, maximum contract amounts are set regionally based on the perceived need or availability of funds.
- At DPRS, the budgets for adoption brokers, in-home casework and case management contracts, and preparation for adult living contracts are set regionally with only limited guidance from DPRS. Although it is important to allow the regions a certain amount of flexibility in setting budgets so that differences in geography and demographics can be recognized, without providing standard guidelines regarding the maximum amounts which should be paid for services, DPRS has no assurance that it is paying a reasonable amount for these services. For example, we found that the provider of the adoption broker contract was paid a 10 percent administrative fee which was arbitrarily established by the regional office without any analysis of the costs incurred by the provider.

Section 2-C:

Current Fiscal Oversight Does Not Provide Reasonable Assurance That Inappropriate Expenditures Are Detected

The nature and extent of fiscal oversight of contractors varies from agency to agency. While TDH has a well-defined financial monitoring function, we still found some operational problems which prevented TDH from providing reasonable assurance that inappropriate uses of funds are detected and recovered. On the other hand, DPRS does not have a standardized statewide financial monitoring system in place for cost-reimbursement contracts.

TDH's Grants Management Division performs fiscal audits of providers who receive \$25,000 or more from state and federal sources at least once every two years. During the review, monitors select one month from a sample quarter to trace expenditures to quarterly budget reports and supporting documentation. If questioned costs are identified in the sample, TDH either requests reimbursement for the questioned amount or withholds that amount from future reimbursements. *However, additional*

months are not routinely tested to ensure that similar expenditures were not made and claimed in other months.

All eight of the TDH providers reviewed had been reviewed by TDH prior to our audit. However, our review of providers still found instances of potential questioned costs and weaknesses in providers' systems of internal controls not identified by the TDH audits. For example,

- We reviewed one HIV/AIDS provider and found \$102,299 in questioned costs. Examples of the questioned costs include the following:
 - Payments of \$7,923 made to a related party for purchases of equipment made without the benefit of a competitive procurement process and a large number of questionable telephone repair services such as turning the phone ringer on and plugging a power cord into the wall.
 - \$10,000 in purchases made on the last day of the contract. The items purchased were not disbursed to clients during the contract period.
 - \$1,780 in expenditures which were overallocated to TDH and \$3,115 in payments made without the documentation required by program standards.
- At another HIV/AIDS provider, we found over \$5,400 of expenditures which were made without obtaining the documentation required by the contract.

Although TDH's financial reviews provide some assurance that funds are used appropriately, limiting the reviews prevents monitors from detecting additional instances of inappropriate expenditures.

On the other hand, DPRS does not routinely monitor the financial records of cost-reimbursement contractors to determine the appropriate use of funds. While DPRS does conduct an annual financial review of the services to runaways and at-risk youth contractors, in the case of other contracts, such as in-home casework and case management contracts, post-adoption contracts, preparation for adult living contracts, and guardianship contracts, the extent of the financial monitoring conducted is generally decided by DPRS' regional staff.

DPRS has recognized the need to improve financial monitoring of its contractors and has recently reassigned staff to form a new Contracts Office within the agency's Financial Division. Plans are underway to hire additional staff for this office as well. The primary purpose of this office is to develop and implement an accountable, auditable, and user-friendly contracting system for DPRS. It is intended that agency program staff will work jointly with the new Contracts Office to develop a means of assessing the quality of contractor services.

Section 3:

The Majority of Health and Human Services Contractors Are Not Selected Using Competitive Procurement Processes

Traditional competitive procurement procedures were not used to award the majority of the contracts reviewed. While adequate contract provisions, establishment of reimbursement amounts, and financial monitoring are crucial to ensure quality and efficient service delivery, funding agencies must also strive to use effective and objective procedures to award contracts. Competition can provide a benchmark for measuring the quality and cost of public services and helps reduce the risk of bias or favoritism in the selection process. When competition cannot be used, other compensating methods must be developed to ensure that the best possible contractor is selected to provide services at the best possible price.

For many programs reviewed, contractors are selected through an enrollment method. This method allows any provider who obtains a license and meets applicable program standards to become eligible for a contract for services.

For those funding agencies that do use a competitive procurement method, we found weaknesses which prevent the agencies from ensuring that the best contractor is objectively selected. For example, some programs attempt to use a competitive process, but competition is limited to existing contractors or contract renewals are automatic.

Section 3-A:

Enrollment Process Limits Objectivity of Contractor Selection Process

The use of an enrollment process limits the funding agencies' ability to objectively select the most qualified and efficient contractors. DHS, DPRS, and the Department of Mental Health and Mental Retardation (TDMHMR) all use an enrollment process for contractor selection for some programs. In some cases, the use of an enrollment process is mandated by the Federal Government, but in others, an enrollment process was developed to compensate for the limited number of providers available to provide a given service.

For example, for the Nursing Facility program at the DHS, any facility which is licensed and certified is eligible to receive a contract, subject to the documented need for beds based on the occupancy rate of Medicaid certified beds. Our testing of four Nursing Facility providers found that they all had received contracts for a number of years. Even though they are annually recertified (i.e., tested for compliance with standards), there is no competition for the limited number of providers within a given area because *contracts with current providers are always renewed unless the provider is found to be in noncompliance with standards.*

There is currently a moratorium in effect which requires the occupancy rate for nursing homes in a given area to exceed 90 percent for six months before any new nursing

home beds can be contracted for. But when new beds are needed, they are awarded to current providers first. As a result, even if a nursing home has an occupancy rate of below 90 percent because of marginal services, *a new provider would not be allowed to receive a contract in the area, thus ensuring that the marginal contractor retains the contract.*

Section 3-B:

Some Programs Award Contracts Without Using Standard Selection Procedures or Limit Who Can Compete for Contracts

Several programs reviewed awarded contracts using an informal selection process. Others limited who could compete for contract awards to existing providers. Without established procedures for evaluating and selecting contractors, agencies may not be receiving the most value for their contracting dollars. Because these programs award contracts with little or no competition, there is little assurance that the best provider is selected.

Our review of programs at TDH, DPRS, and DHS found:

- Contractors for WIC services at TDH are selected informally. TDH does not have written procedures for the evaluation of contractors' proposals and does not document its selection process.
- At DPRS, both the adult guardianship and adoption broker contractors were selected informally without the benefit of competitive procurement procedures.
- Contracts with existing Family Planning (Title X and Title XX) providers at TDH are automatically renewed without the benefit of competition. New providers are solicited only if additional funds become available.
- At DHS, the Title XX Home Delivered Meals Program does not advertise procurements so that potential contractors know to apply.

Section 3-C:

When Competitive Bidding Is Used, Weaknesses in the Bid Evaluation Process Impair the Effectiveness of the Process

When agencies use a competitive bid process, we found that weaknesses in the bid evaluation process impair the effectiveness of the process for some programs. Current bid evaluation processes do not ensure that the highest rated contractor is selected. Additionally, although programs have developed evaluation instruments for raters to use in scoring provider proposals, wide variations in raters' scoring suggests that these instruments are not clear enough to ensure consistent scoring and evaluation among rates.

TDH uses competitive bidding to select contractors for the HIV/AIDS Early Intervention Projects (EIP) and Education Grants Programs. However, the proposal with the highest combined average score in a region or city is not necessarily the provider selected. In our review of awards of EIP and Education Grant funds, we found that EIP contract awards were made to providers who did not have one of the grouping's highest combined average scores.

Additionally, raters' scores of provider proposals varies considerably. For instance, for the nine providers who received EIP contracts, low and high scores varied by as much as 46 points (of 110 points maximum). This suggests that the evaluation instrument's criteria are not clearly defined. TDH does not train evaluators on the use of the instrument and relies on the reported expertise of the external raters to ensure understanding of the evaluation instrument.

Section 4:

There Is a Lack of Central Guidance or Oversight of Contract Administration Efforts Which Results In Duplication of Effort and a Piecemeal Approach on a Statewide Basis

Statutes and agency policies governing the use of public funds vary significantly among agencies. Statutes and policies are also inconsistent between state and federal funding sources. This creates confusion for providers as to which requirements apply to which funds and makes contracts more difficult to administer and enforce.

For example, both TDoA and DHS administer programs which provide home-delivered meals to those in need of services. Two of the service providers audited had contracts with both TDoA and DHS. Although the contractors provide essentially the same services, the contractual restrictions over use of the funds vary significantly. TDoA contract provisions require compliance with federal cost principles which restrict the use of funds and require the contractor to reimburse TDoA for unallowable expenditures. On the other hand, DHS contracts do not contain provisions which limit the contractors' expenditures to the reasonable and necessary costs of providing services, nor do they require the contractor to reimburse DHS for inappropriate expenditures.

Inconsistencies in the statutes and policies governing the uses of public funds have contributed to inadequacies in contract provisions. The only uniform state-mandated standards for contract and grant administration are the Texas Uniform Grant and Contract Management Standards (UGCMS). In accordance with state regulations, UGCMS adopts contract and grant management standards established by the Federal Government and applies them to grants and contracts made with state funds. However, pursuant to restrictions contained in the Uniform Grant and Contract Management Act of 1981, *the standards only apply to grants and contracts with other state and local governments.*

The UGCMS does not apply to non-profit or for-profit organizations' use of state funds. In contrast, the Federal Government has a separate set of cost principles which apply to grants and contracts with each type of organization. Currently, the Governor's Office is leading a working group to revise the UGCMS. An issue under consideration by the group includes the applicability of the requirements to all types of contractors, not just state and local governments.

Another problem is that although multiple state agencies often use the same contractor, there is no coordination or communication among agencies regarding the contractor's performance. Each agency representative monitors for its own particular compliance issues which result in the failure to see the "big picture." As a result, issues such as double billing and payment of different rates for the same services can be easily overlooked.

One service provider reviewed had recently been audited by DHS, DPRS, TYC, and TCADA. *Although the State paid for four agencies to monitor the same provider, none of these monitors noticed that the State was being charged twice for the same services.*

During our review of the HHS service providers, we noted that the 20 providers had been monitored at least 63 times combined by all of the funding agencies during fiscal years 1994 and 1995. One provider reviewed was audited by seven different funding agencies with whom it had contracts with during the year. However, none of these seven audits focused on the fiscal accountability of the provider.

In an attempt to address such inconsistencies, the Health and Human Services Commission is heading a multi-agency contract management committee made up of representatives from all of the health and human services agencies. The purpose of the committee is to:

- Develop a system of contract management by health and human services agencies that:
 1. ensures fiscal and programmatic accountability in all contracts, including adequate sanctions to ensure compliance
 2. provides appropriate consistency across agencies in contract procurement methods, language and format, management and monitoring, and auditing and evaluation activities
 3. maximizes efficiencies across agencies
- Describe the system concretely and concisely in order to be able to educate contractors, the public, and governmental oversight entities about the system.

Although the identification and implementation of standardized "best practices" for health and human services agencies is a step in the right direction, it does not address *statewide* contract administration issues. Thirteen of the 20 HHS service providers

reviewed also had contracts with non-HHS agencies such as the Texas Department of Housing and Community Affairs and TYC. In total, these 13 providers received over \$30 million from non-HHS agencies during fiscal year 1994.

Section 5:

Other States Have Additional Controls over Contractors That Could Be Applied to Texas Contractors

Like Texas, other states use contractors to provide various services to their citizens. Our research indicates that there is a wide variety of methods used to protect taxpayer funds and that there is no consensus on what constitutes the best method of contract administration. However, to ensure financial economy and accountability, some states have imposed stronger fiscal controls over contractors than the controls typically used in Texas. Such controls include the following:

- **Cost Settlements** - In reviewing other states' mental health programs contracting processes, TDMHMR's Internal Audit Department found that six of nine states' contracts required a cost settlement at the end of each fiscal year. While the form of the cost settlement varies from state to state, this requirement allows states to recover any funds distributed to a contractor which are in excess of the actual cost incurred to provide the service. For example, in New York, if a county/provider has spent less than what was agreed to in the contract, the unspent funds are recouped by reducing the next payment to the county/provider. On the other hand, in New Hampshire, three percent of the total contract funds are withheld from provider payments until a cost settlement is conducted at the end of the fiscal year.
- **Detailed Review of Caps on Administrative Costs** - TDMHMR's Internal Audit Department also found that most states surveyed carefully monitor the indirect costs charged to state programs and that some states limit the amount of funds provided for administrative costs or refuse to fund providers' indirect costs. Caps have also been considered for other programs. For example, in 1994 a consultant reviewed New Mexico's rate-setting process for children's residential services and recommended that the state cap administrative expenses at 15 percent of total costs.

In addition to reviewing contract controls, we researched other states' methods for establishing contract rates and payment amounts. We found that states use a variety of methods for determining contract amounts:

- In Missouri, the majority of contracts are awarded through an open enrollment process with unit rates established by the legislature based on recommendations submitted by the Department of Social Services and the provider industry.
- In Michigan, the Department of Social Services began moving away from unit rates based on cost information to a more competitive contract award process.

However, according to agency officials, the change has not been entirely successful, and the state has continued to set some standard rates.

- In Pennsylvania, responsibility for evaluating provider costs, setting rates, and assuring the best possible rates rests at the county level. County rate-setting processes vary depending on the size of the county and the number of counties serviced by each provider. In counties with larger client populations, the counties control the rate-setting process. In counties with smaller client populations, the providers control the process and simply notify the county what their rate is.
- In California, rates are based upon the results of a cost study of actual, allowable, and reasonable costs which was conducted in 1985. Each year, the state increases rates by a California inflation factor. (Rates have also been adjusted for increases in the minimum wage.)

While these examples illustrate methods used by other states, additional research would be necessary to determine their effectiveness and applicability to Texas.

OVERALL RECOMMENDATIONS:

As mentioned previously, our review of statewide contracting practices lead us to the conclusion that there is not one "right" way of contracting, and we do not advocate standardization of one method of contracting for all services. Instead, agencies have the responsibility to develop safeguards which will promote the efficient and effective use of public funds, regardless of which method of contracting is used. Factors such as the number of contractors available to provide services and the cost to develop and manage rates must be considered before deciding on the type of contract to use or the method by which rates/amounts will be established.

The intent of these recommendations is to encourage funding agencies to re-examine their current contracting practices and identify cost-effective ways to enhance controls over contractors' use of public funds. We do not intend to suggest that the solution is to substantially increase the resources devoted to the contracting function.

The cost/benefit of strengthening contract administration controls must be considered. Most of the health and human services agencies included in this audit have recently downsized their staffs, including some audit staff. We were repeatedly told by agency personnel that there were not sufficient resources to perform all of the necessary monitoring of contractors. If this is the case, limited resources should be allocated to those functions which provide the best safeguards over taxpayer funds. Current inefficient practices should be eliminated or replaced with procedures which focus on the areas of highest risk.

We recommend that the funding agencies consider the following:

- **Develop and implement contract provisions designed to hold all contractors accountable for the appropriate and effective use of state funds.** In order to ensure that funds are spent in a manner that benefits the objectives of the funding programs, it is essential that the contracts contain explicit restrictions. Monitoring of contractors' fiscal controls is essentially useless if the contracts themselves do not provide the agency with any recourse to recover inappropriately used funds.

This can be accomplished by requiring that all contracts include provisions similar to the federal cost principles related to the allowability of contractor expenditures. Contracts should contain specific definitions of allowable and unallowable costs, as well as provisions which require the contractor to reimburse any funds used inefficiently or inappropriately.

Until improvements in the rate-setting process can ensure correlation between costs incurred and reimbursements received, unit-rate contracts should contain provisions which limit the contractor's reimbursement to the lower of the rate paid or the reasonable, necessary, and allowable costs to provide services. A cost settlement (based on an audit) should be required at the end of the contract term.

As indicated throughout the report, we found numerous examples of unreasonable and unnecessary uses of state funds which are completely acceptable under current unit-rate contract provisions. With these examples in mind, along with similar examples mentioned in previous reports, we cannot support a conclusion that current practices ensure that public funds are used appropriately and efficiently.

We recognize that provisions which limit compensation and require cost settlements at the end of the year may increase administrative requirements and potentially the cost of contract administration. However, this is just one of the options available, and as mentioned previously, we encourage agency management to re-examine current contracting practices and identify cost-effective methods to enhance controls over contractors' use of public funds. We found that there are pros and cons associated with each method of contracting. Ultimately, it will be up to agency management as well as the appropriate oversight bodies to determine the trade-offs between the costs of better controls and the costs of contractors' waste and abuse of public funds.

- **Develop methods of establishing contractor payments that reflect only the necessary and reasonable costs of providing services.** *Regardless of the contract type*, it is essential that the method used to determine contractor reimbursements ensures that the State is paying the best price for the best services. Agencies should establish a standardized methodology to identify elements of cost to be used in determining the contracted rate (to be used by all agencies). This would help ensure that consistent rates (to any single provider) are paid for like services regardless of the funding source. Consideration should

be given to requiring contractors to adhere to state guidelines regarding maximum travel reimbursements and other standards.

Requiring that unit-rate contracts include end-of-term cost settlements will help ensure that contractors are not paid for expenditures which do not benefit the program's objectives. Agencies could also consider adjusting standard rates to compensate for providers' unique situations (such as geographic location or size) so that the rates would better reflect the reasonable and necessary costs associated with providing the services.

If rates are based on cost report data, methods to verify the accuracy of provider-reported cost data should be strengthened. The number of field audits should be sufficient to provide reasonable assurance that the reported costs are accurate. Stronger sanctions should be developed and implemented for reporting false data on cost reports. In addition, cost report training should be mandatory for all providers.

We also recommend that the Health and Human Services Commission seek clarification regarding the expectations surrounding its role in the rate-setting process and establish the necessary functions to fulfill the expectations.

Agencies that use cost-reimbursement contracts should develop criteria to evaluate providers' proposed budgets. Criteria should specify acceptable ranges of cost for each cost category (either in total dollars or as a percent of other categories). Particular attention should be paid to administrative and indirect expenditures. Consideration should be given to setting caps for these costs.

- **Establish centralized oversight responsibility for contract management of service providers, in particular fiscal monitoring.** The contract monitoring function would be enhanced by a comprehensive review of a provider's total state funding sources, not just those received from one agency. A review of all funding sources within a single monitoring visit would increase the detection of irregularities such as double billing.

In addition, centralized oversight would allow for more efficient use of resources on a statewide basis. A provider who contracts with multiple agencies would be financially audited one time, with comprehensive coverage of all funding sources, instead of separate audits by multiple agencies.

Centralized contractor information also enhances risk assessment and analysis capability by providing an opportunity for comprehensive statistical analysis of statewide data to be used for rate setting and other purposes.

- **Use competitive procurement procedures whenever possible.** Competition helps ensure that rates/contract amounts are reasonable and the lowest possible, while still maintaining quality services.

In addition to the recommendations listed above, specific recommendations for DHS, DPRS, TDH, and TDMHMR are included in sections 6 through 9 of the report, respectively.

Section 6:

Current Contracting Practices Do Not Enable the Department of Human Services to Prevent Inappropriate or Inefficient Use of Public Funds

DHS unit-rate contracts do not limit the contractors' use of public funds to the reasonable and necessary costs of service delivery. As a result, as long as services are delivered in accordance with the terms of the contracts, providers can spend funds in any way they choose without violating the terms of the contract. As the reimbursement rates established by DHS sometimes exceed the provider's costs of service delivery, there is an even greater risk of waste and ineffective use of public funds.

DHS contracts with providers for several types of purchased services. We reviewed nine providers whose contracts totaled over \$41 million. The types of contracts reviewed during this project, as well as the corresponding contractor selection procedures and payment methodology, are listed in Figure 5.

Figure 5
Summary of Department Contracts Reviewed

Contract Type	Contractor Selection Procedures	Payment Methodology
Child Care Management Services	Competitive Bid	Combination - Costs for operation of the program are set up as a cost-reimbursement contract. Maximum rates for the direct services portion of the services are based on market studies.
Child and Adult Care Food Program	Open Enrollment	Providers submit budgets for the administration costs of the program. The Federal Government sets the unit rates for the meals. The administration costs are covered in the rates.
Temporary Emergency Food Assistance Program	Limited Open Enrollment	Cost Reimbursement.
Title XX Home Delivered Meals	Competitive Negotiation	Unit Rate.
Nursing Facility Program	Limited Open Enrollment	Unit rate computed with cost report data. Unit rates are associated with a Level of Care system.
Hospice	Open Enrollment	Unit rate computed with cost report data. Unit rates are associated with a Level of Care system.
Primary Home Care	Open Enrollment	Unit rate computed with cost report data. Unit rates are associated with levels of service delivery.
Community Living Assistance	Open Enrollment	Unit rate computed with cost report data.

Section 6-A:

Unit-Rate Contracts and Current Monitoring Practices Do Not Limit the Use of Public Funds to the Necessary Costs of Providing Services

DHS' unit-rate contracts do not hold contractors accountable for **how** they spend public funds. Contracts require providers to deliver the services specified in the contract for a predetermined rate, but do not contain restrictions which limit contractor expenditures to the reasonable and necessary costs of providing services. Although we found over \$500,000 in questionable expenditures at the contractors reviewed, these expenditures are not violations of agency regulations or contract provisions as currently written.

DHS' unit-rate contracts contain provisions which require the provider to comply with regulations published in the *Texas Register*, including rules which specify allowable and unallowable expenditures. However, these requirements only restrict the

expenditures which can be included on cost reports used in the rate setting process, not what the contractor can actually use the funds for. Consequently, *contractors are still allowed to spend public funds on items that may be otherwise considered inappropriate as long as the costs are not included on the cost report.*

For example, we found that a Primary Home Care provider paid over \$104,536 for a computer lease to a company owned by the provider's president. For cost report purposes, the cost of the lease must be reduced to the lower of the actual cost or the price paid by the related party. In this case, the related party's cost for the computers was only \$34,156, which was appropriately included in the cost report. However, the provider actually spent \$104,536 (\$70,380 over the actual cost) for the use of the computers. As this provider receives the majority of its funding from DHS, state funds were clearly used to finance the computer lease.

The agency's contract monitoring efforts primarily focus on service delivery and compliance with program standards instead of the appropriateness of contractors' expenditures. Although both aspects are important, because the contracts do not restrict the use of public funds, monitoring the appropriateness of contractor expenditures is viewed as unnecessary.

However, in some cases, DHS does monitor other financial aspects of the providers' operations. For example, the Utilization and Assessment Review Section of the Nursing Facility Program performs on-site audits of client records to ensure that DHS pays for each resident's care at the appropriate level. These reviews provide some fiscal controls by ensuring that the contractor does not bill DHS for services that have not been provided. DHS also performs financial reviews of client trust funds for the Nursing Facility Program.

During our review of contractors, we identified examples of expenditures which would be considered unallowable or questionable if the contract limited actual expenditures according to criteria contained in the Texas Administrative Code or federal cost principles. Examples include the following:

- One contractor made either inappropriate or unsupported expenditures of \$267,292. Examples included payment of management and consulting fees (some of it to related parties), travel expenses, advertising expenses, and other administrative expenses for which there was no documentation to support that the expenditures were related to the objectives of the program. When questioned about the nature of these expenditures, the provider did not seem concerned and simply stated, "I guess we didn't do a very good job."
- One provider made over \$61,805 in inappropriate or unnecessary expenditures such as entertainment, interest on borrowed capital, unsupported payments to consultants, and improper allocation of employees' salaries.
- One provider spent over \$13,000 on flyswatters and calendars to advertise their services.

Section 6-B:

Current Rate-Setting Methodologies Do Not Provide Reasonable Assurance That the State Is Paying a Fair and Reasonable Rate for Services

The current methodologies used to establish rates do not provide reasonable assurance that the contractor is compensated only for the reasonable and necessary costs (which includes a profit margin for the for-profit contractors) of service delivery. We found that contractor expenditures were sometimes excessive, inappropriate, or not related to program objectives. Although there are currently no standards which address the reasonableness of expenditures such as provider compensation, excessive expenditures do cause us to question if DHS is paying a fair and reasonable rate for the services provided. For example, at one service provider who receives the majority of its funding from DHS, we noted the following examples of expenditures which may not represent the most cost-effective use of state funds:

- The primary home care provider leased computers from a company owned by the provider's president and vice president. The provider leased computers at an average cost of \$432 a month, resulting in an average annual rental cost of \$5,184 per computer (based on the invoices reviewed). For the contract year reviewed, the provider paid \$104,536 to the related party company for the computer leases, resulting in a \$70,380 profit. In addition, the same president and vice president own the building which the provider leases and recognized a profit on the lease of \$14,386.
- During the contract year reviewed, the four family members, along with the administrator, together received \$1,099,655 in total compensation. (The company received total revenues of \$13,954,751, or 89 percent of its revenue from DHS.)

The examples identified above resulted from unit rates established based on cost report information submitted annually by service providers. DHS calculates the rates using allowable costs included in cost reports submitted by the service providers. The rates for the Nursing Facility, Primary Home Care, and Community Living Assistance Programs are all calculated using providers' cost report data.

The rate-setting methodology itself is well-defined for each program and includes edit checks, data analysis, audits of cost reports, informal reviews, and public hearings. (See Figure 4, page 14 for a flowchart of the process.) In addition, DHS has recently proposed revisions to the Texas Administrative Code which are designed to build more accountability into the cost report rules by strengthening cost determination requirements. However, we noted the following weaknesses in DHS' process:

- **All providers are paid the same rate for the same class or level of service, even if costs of service delivery differ.** The inherent flaw with the methodologies used to establish reimbursement rates is that they are primarily based on the median costs of all providers of a particular service plus a mark-up factor determined by DHS. (The Nursing Facility Program does not use the

median cost for all components.) Variations in costs of doing business in different parts of the State are not taken into consideration, nor are differences between for-profit and non-profit providers considered. Thus, a provider in a rural area may have lower costs, but will be paid the same rate as a provider in an urban area who has higher costs or vice-versa.

- **There is little assurance that the information used to calculate the rates is accurate.** Only 10 to 15 percent of the cost reports for each program receive *field audits* annually. Although all remaining cost reports receive a *desk review*, these reviews are limited in scope and are not comparable to an actual audit of the financial information.

For example, in our field audit at a nursing home provider we found approximately \$260,000 in questionable costs which should not have been included in the fiscal year 1994 cost report. The questionable expenditures included \$132,000 in management and consulting fees paid to a company owned by the same husband and wife team who own the nursing home (in addition to their regular salaries). The providers could not provide any documentation that the owners had actually provided services to the nursing home for these payments.

Although the Department performed a desk review of this cost report, the main adjustment was to remove \$132,000 in management fees because they had also been reported in overhead expenses and \$100,903 in building lease expense to reduce the amount paid to a related party. Thus, while the desk review resulted in an appropriate reduction of the provider's reported costs, the additional \$260,000 in questionable expenditures identified during the course of our field audit were still included in the data base used to calculate the rates.

- **There are no serious consequences for filing inaccurate cost reports.** *If unallowable expenditures are discovered in the audit of a cost report, the provider is not required to reimburse the funding agency.* The service provider is given notice of what needs to be corrected and required to remove the expenditures from the cost report so they are not used to calculate the rates.

Chapter 40 of the Texas Administrative Code does allow DHS to place a hold on vendor payments for such things as submitting an unauditible cost report, filing a late cost report, or failing to give access to field auditors. The agency's current rules allow the contractor 90 days to bring records into compliance or payments are withheld. (The agency has proposed rules which will decrease the time to 30 days.) During fiscal year 1994, DHS was unable to impose vendor holds against providers for submitting an unauditible cost report due to changes in state legislation. However, DHS has now adopted rules which allow the vendor holds to be implemented. Three vendor holds were implemented against nursing homes for failure to submit cost reports by the due date during fiscal year 1994.

- **Currently, it is not mandatory that providers attend training on cost report preparation.** The providers receive explicit instructions for preparing the cost report and notification of training classes, but providers are not required to attend. DHS has proposed rules which will make cost report training mandatory for all providers. During our review of providers, we found that there was a lack of accounting experience at the provider level which also raises concerns about the quality and accuracy of information included on the cost report.
- **There are no standards for computing costs such as administrative expenses.** Without defining standards for certain costs, DHS cannot compare costs between providers and evaluate efficiency. For example, our analysis of fiscal year 1993 cost report data for the Nursing Facility Program found that total administrative expenses ranged from 74 percent of total expenses to two percent of total expenses. For the primary home care program, total administrative expenses ranged from 56 percent to five percent of total expenses. This wide variation appears to indicate that some providers are more efficient than others, but without established standards or definitions of administrative expenses, a true comparison cannot be made.

DHS has set caps for the reporting of compensation of owners, partners, and stockholders for the Nursing Facility Program, but not for any of the agency's other programs. Under this cap, the total compensation which is figured into the rate-setting base is limited to \$55,568 for the administrative salaries and wages of an owner, partner, or stockholder. This provides some assurances that excessive salaries are not included in the data used to calculate the rates, but it still does not preclude the provider from using DHS funds to pay higher salaries.

Our analysis of the fiscal year 1993 cost report data for the Primary Home Care Program also indicated that a number of providers received an excess of funds from DHS over and above their total expenses. Further analysis indicated that the highest "profits" (although some of these providers were non-profit organizations) were achieved by those programs which had the highest number of service hours. This indicates that contractors who provide services in high volume receive the highest profit since once they have covered their fixed costs at a certain level of service, the profit margin is higher on the remaining hours of services.

Based on a practice used in the private sector, where bulk purchases are usually discounted, we developed a hypothetical reimbursement model which would provide DHS with a "discount" for "bulk" purchases of services. Under this model, we assumed that for hours of service in excess of 500,000, the provider would only be reimbursed 90 percent of the regular flat rate. Application of this model affected 17 of the Primary Home Care providers (i.e., those who had over 500,000 hours of service in fiscal year 1993). Based on the results of our application, *DHS would recognize a savings of \$5.5 million annually.*

Although this hypothetical model is simple and not based on a statistical methodology, it indicates that minimal adjustments to the rates could result in considerable savings to the State. The profit margin for the 17 providers affected by the discounted rate still

ranged from .6 to 17 percent after the application of the discounted rate. As the providers are still earning money with each additional hour, there is no disincentive to stop providing services over the discounted level. In addition, the level of hours and the amount of the discounted rate can easily be changed to arrive at an agreeable rate for all parties.

The weaknesses in the agency's rate-setting processes have been reported on previously. In a report issued in 1992, *Program Audit of Long-Term Care Services to the Aged and Disabled* (SAO Report No. 92-120, May 1992), the State Auditor identified the following weaknesses in DHS' rate-setting methodology for long-term care services:

- DHS should consider using uniform regional boundaries in H.B. 7, 72nd Legislature, or other appropriate demographic criteria to stratify the reimbursement rates paid to nursing facilities.
- DHS should increase the number of annual field audits performed (from 10 percent).
- DHS should develop its audit plan based on risk assessments of the cost reports.

During our current project, we found that DHS has not implemented the use of demographic criteria to stratify the reimbursement rates and has not increased the number of cost report audits performed each year. DHS has developed a formalized risk assessment process for the Intermediate Care Facility for the Mentally Retarded (ICF-MR) and Nursing Facility Programs.

Some of the programs reviewed used alternative methods of establishing rates. For example:

- The Title XX Home Delivered Meals Program uses competitive negotiation to establish rates. Although this method allows rates to be tailored to meet the needs of each location, the accuracy of the negotiated rates depends upon the skills and knowledge of DHS' regional negotiators. As the agency has not prepared written policies and procedures to assist regional contract managers in negotiating the rates, variation in rates may be based on negotiator skills rather than on true differences in costs to provide services.
- The Child Care Management Services (CCMS) Program establishes rates for the child care direct services portion of its contracts. (Funding for the administrative portion is cost reimbursement.) Rates are based on a biennial market survey of child care facilities throughout the State. The maximum reimbursement rates are set based on the 75th percentiles of market rates, as determined by a survey conducted by The University of Texas. The rate-setting process creates a possibility of 32 different rates for each provider.

As the direct services portion of this contract is essentially a "fee-for-service" type of arrangement, it was difficult to assess the reasonableness of the rates during our

audits of service providers. Providers are paid a daily rate based on attendance of children enrolled in the CCMS program. A provider may only have one or two CCMS children enrolled in its day care center along with multiple private pay clients. As a result, the day care center's accounting records will reflect the total costs of providing services for all children, not just those associated with the CCMS children.

DHS has established a system to ensure that only eligible and authorized clients are included on billings and paid by the agency. Payments to contractors are verified through the computer system, which contains a number of edit checks.

Section 6-C:

Federal Requirements Limit Use of Competition in Contractor Selection Process

Of the eight DHS programs reviewed, only two (CCMS and Title XX Home Delivered Meals) use competitive procurement procedures to select contractors. The rest of the programs all use some variation of an enrollment process. For some of these programs, the use of an enrollment process is mandated by the Federal Government. Although the processes used by each program vary somewhat, the enrollment process allows providers who meet the applicable criteria for each program to be eligible to obtain a contract. As a result, DHS is prevented from using competition to objectively select the most qualified and efficient contractor.

For example, for the Nursing Facility Program, any facility which is licensed and certified is eligible to receive a contract, subject to the documented need for beds based on the occupancy rate of Medicaid certified beds. Our testing of four Nursing Facility providers found that they all had received contracts for a number of years. Even though they are annually recertified (tested for compliance with standards), there is no competition for the limited number of providers within a given area because *contracts with current providers are always renewed unless the provider is found to be in noncompliance with standards.*

There is currently a moratorium in effect which requires the occupancy rate for nursing homes in a given area to exceed 90 percent for six months before any new nursing home beds can be contracted for. But when new beds are needed, they are awarded to current providers first. As a result, even if a nursing home has an occupancy rate of below 90 percent because of marginal services, *a new provider would not be allowed to receive a contract in the area, thus ensuring that the marginal contractor retains the contract.*

In the Child and Adult Care Food Program (CACF), which is also an enrollment program, DHS can declare a provider who is not performing as "seriously deficient" so that it can never contract with the CACF program again. Since 1992, DHS has declared 22 providers seriously deficient and has also published rules to tighten the eligibility rules for potential providers.

Recommendations:

We recommend that the Department consider the following:

- Review and amend each contract type to ensure that the contracts contain clear provisions which set forth the definitions of allowable and unallowable costs under the contracts, as well as provisions which require the contractor to reimburse any funds used inefficiently or inappropriately.

Unit-rate contracts should contain provisions which limit the contractor's reimbursement to the lower of the rate paid or the reasonable and allowable costs of providing the services. A cost settlement should be required at the end of the contract term.

- Review, strengthen, and/or adjust the existing rate-setting methodologies to ensure that the methods used to establish rates provide reasonable assurance that the State is paying the best price for the best services.

If rates are based on cost report data, methods to verify the accuracy of provider-reported cost data should be strengthened. The number of field audits should be sufficient to provide reasonable assurance that the reported costs are accurate. Stronger sanctions should be developed and implemented for reporting false data on cost reports. In addition, cost report training should be mandatory for all programs.

Section 7:

The Department of Protective and Regulatory Services' Contract Administration over Certain Purchased Services Does Not Ensure That Public Funds Are Used Appropriately and Efficiently

DPRS does not have adequate controls in place to ensure that its contracts for certain purchased services are effectively and efficiently administered. Specifically, weaknesses in contract provisions, fiscal oversight, and calculation of unit rates and contract budgets preclude DPRS from consistently ensuring that public funds are used appropriately. In addition, DPRS' procedures for awarding contracts could be improved to better ensure that the best contractors are objectively selected.

DPRS administers several different types of contracts for purchased services. We reviewed four providers whose contracts totaled over \$9 million. The types of contracts reviewed during this project, as well as the corresponding contractor selection procedures and payment methodology, are listed in Figure 6 (on the following page). Contracts for services provided directly by foster families were not included in this review.

Figure 6
Summary of DPRS Contracts Reviewed

Contract Type	Contractor Selection Procedures	Payment Methodology
Residential Treatment Center (RTC)	Contractors are chosen through a contractor enrollment process.	Unit rate per child per day; unit rates are associated with DPRS' Level of Care system.
Child Placing Agency (CPA) for Foster Care	Contractors are chosen through a contractor enrollment process.	Unit rate per child per day; unit rates are associated with DPRS' Level of Care system.
Adoption Broker Contract	Contractor was chosen by DPRS regional office staff based upon prior associations with the contractor; no competitive bid process was used.	Contractor was paid a 10 percent administrative fee to act as the reimbursing agency for adoptions handled by adoption agencies.
Adult Guardianship	Contractors are selected through an informal process.	A contract budget is established.
In-Home Casework and Case Management	Contractors are chosen through competitive bid procedures and handled at the regional level. Each region can use different selection procedures.	Contract payment methods vary by region. Some regions use a unit rate, while others use a fixed budget.
Preparation for Adult Living (PAL)	Contractors are chosen through competitive bid procedures and handled at the regional level. Each region can use different selection procedures.	Contract payment methods vary by region. Some regions use a unit rate, others use a fixed budget, and others use a combination of both methods.
Post Adoption	Contractors are chosen through competitive bid procedures and handled at DPRS headquarters. Each of the agency's regional offices then selects contractors based upon the bid evaluations conducted at DPRS headquarters.	Rates are set forth in the contract for the various services provided. Rates can vary by region.
Services to Runaways and At-Risk Youth (STAR)	Contractors are chosen through competitive bid procedures handled entirely at DPRS headquarters.	A contract budget is established.

Section 7-A:

Weaknesses in Contract Provisions and Financial Monitoring of Unit-Rate Contracts, As Well As in the Calculation of Unit Rates Themselves, Increase the Risk That Funds Will Be Used Inappropriately

DPRS' unit-rate contracts do not limit contractors' use of public funds to the reasonable and necessary costs of providing services. Although we found over \$1.6 million in questionable expenditures, these expenditures are not violations of the contract provisions as currently written. As there are no restrictions over the use of funds, DPRS focuses its monitoring efforts on delivery of services, not the appropriateness of contractor expenditures. In addition, multiple weaknesses in the agency's procedures for calculating unit rates result in some providers receiving compensation which exceeds the reasonable and necessary costs of providing services.

Unit-Rate Contracts Do Not Hold Contractors Accountable For The Appropriate Use of Public Funds. The Department's unit-rate contracts for residential treatment and child placing agency services do not hold contractors accountable for **how** they spend public funds. It is critical that the contract language contain clear provisions outlining the definitions of allowable and unallowable costs, as well as the manner in which the contractor will report the status of its financial position to DPRS in order to ensure funds are spent appropriately.

The Child Placing Agency and Residential Treatment Center contracts currently consist of the same three-page agreement. The current contracts are open-ended and contain no ending or renewal dates. We noted the following weaknesses in the contracts which limit the contractors' fiscal accountability:

- Contract provisions do not limit contractor expenditures to the reasonable and necessary costs of providing services. The contracts do not specify the definitions of allowable and unallowable costs, nor do they contain references to federal cost principles which would offer guidance in the determination of allowable versus unallowable costs.
- Contract provisions do not contain explicit language requiring the contractor to reimburse the agency for inappropriate expenditures.
- Contracts do contain provisions requiring the contractor to meet licensing standards. One of the licensing standards, as specified in the Texas Administrative Code, is that a facility must submit a copy of its financial audit to the agency's Licensing Division. However, when we inquired with DPRS licensing staff about what is done with these audit reports, we found that the Licensing Division only requires these audit reports from contractors who are handling adoptions.
- The Child Placing Agency contracts contain no provisions limiting or prohibiting the retaining of a portion of the reimbursement rate at the Child Placing Agency prior to paying the actual foster care home. This is contradictory to the federal

Department of Health and Human Services Administration for Children and Families Policy Announcement 82-01 which prohibits this activity.

In a 1994 survey conducted by DHS, foster families reported that they were paid a wide variety of rates by child placing agencies. For example, DPRS pays child placing agencies \$82.64 per day for children assessed at Level of Care 4. However, survey results indicated that foster care families with which these children reside only received from \$21.00 per day to \$65.00 per day from the child placing agencies.

DPRS has taken steps to address some of the deficiencies in the contracts. A recent rule change approved by the DPRS board will begin limiting the 24-hour child care services contracts to two-year terms beginning in January 1996. Contracts may be renewed upon expiration of the two-year term. DPRS has also drafted a new revision of the contract for residential services, but this revision is not yet in use. However, the proposed revisions do not address or correct the issue of child placing agencies retaining a portion of the reimbursement rate.

Monitoring of unit-rate contractors does not focus on fiscal accountability.

DPRS' current monitoring efforts focus on service delivery instead of the appropriateness of contractors' expenditures. Both aspects are important, but since the contracts themselves do not restrict the use of state funds, monitoring has historically focused on the quality of services delivered. The primary form of fiscal control over unit-rate contractors consists of an annual requirement for the contractor to submit a cost report to be used in the rate-setting process. Also, prior to 1994, all contractors were not even required to submit a cost report.

Although the Texas Administrative Code clearly outlines the definitions of allowable and unallowable costs for 24-hour care services, the requirements only restrict the expenditures which can be included on the cost report, not what the contractor can actually use the funds for. Consequently, contractors are still allowed to spend state funds on items that may be otherwise considered inappropriate as long as the costs are not included on the cost report.

The confusion regarding allowable and unallowable costs is best illustrated by a comment made by one contractor we visited. When we brought certain questionable costs to this contractor's attention, the contractor responded by stating that, as long as these costs were not included on the contractor's annual cost report, the State was not really funding the expenditures, and, therefore, they were acceptable. Because contractors are not compensated for only the costs they report on their cost reports, this is an invalid premise.

During our review of contractors, we found significant examples of inappropriate expenditures which could be considered unallowable if contracts limited provider expenditures according to criteria contained in the Texas Administrative Code or federal cost principles. Examples include the following:

- One contractor engaged in numerous questionable related-party transactions involving the executive director, the executive director's family members, or other contractor employees. Examples of these transactions include the purchase of the executive director's home, purchase of land from the executive director, and payment of monthly deferred compensation to the executive director's former husband who had previously worked for the contractor. The dollar amounts associated with these related-party transactions totaled over \$1.2 million.
- One residential treatment center contractor was using the executive director's home as one of its campuses. This location was not properly licensed, and the contractor owed the residential treatment center \$58,903 in accumulated monthly advances.
- Two contractors made inappropriate expenditures of contract funds or expenditures which could not be supported by adequate documentation. These inappropriate or unsupported expenditures totaled \$299,319. Examples of these purchases included purchases of employee gifts, the purchase of land and blueprints for a church complex, questionable training expenditures, and fund-raising costs which exceeded fund-raising proceeds.
- One contractor employed questionable payroll-related practices such as the loans and advances to employees. Costs questioned in this category totaled \$47,192.

In addition, we found that three contractors had weaknesses in internal controls. These weaknesses included things such as failure to document accounting or purchasing policies and procedures, failure to conduct regular inventories of property and equipment or record who has been assigned responsibility for these items, and failure to maintain up-to-date personnel files and correctly record employee hours worked.

DPRS has recognized the need to improve financial monitoring of its contractors and has recently reassigned staff to form a new Contracts Office within the agency's Financial Division. Plans are underway to hire additional staff for this office as well. The primary purpose of this office is to develop and implement an accountable, auditable, and user-friendly contracting system for the agency. It is intended that DPRS program staff will work jointly with the new Contracts Office to develop a means of assessing the quality of contractor services.

Weaknesses in the agency's procedures for calculating unit rates result in some contractors receiving compensation which exceeds the reasonable and necessary costs of providing services. The current rate-setting process does not ensure that reimbursement rates for Child Placing Agency and Residential Treatment Center contracts reasonably align with the costs of providing services. The rates under DPRS' Level of Care system are established using cost report data submitted annually by contractors supplying 24-hour care services. Under this system, contractors are paid a unit rate per child per day based upon six different levels of care.

The effects of the weaknesses in DPRS' rate-setting process are illustrated by comments from one of the residential treatment contractors reviewed. Specifically, the contractor's executive director indicated that the reimbursement rate for a Level of Care 6 child was too high, and the reimbursement rates for Levels of Care 4 and 5 children were too low. The director stated that, as a result, this facility used the "profit" from the rate received for Level of Care 6 children to help finance the services provided to Levels of Care 4 and 5 children. We were unable to verify this statement, however, as the contractor's accounting records were not organized in a fashion allowing us to see the actual costs incurred in providing services to Levels of Care 4, 5, or 6 children individually.

The weaknesses in DPRS' rate-setting processes have been reported on previously. In a September 1994 report, *A Review of Management Controls at the Texas Department of Protective and Regulatory Services* (SAO Report No. 95-003), the State Auditor's Office identified the following weaknesses in the rate-setting process associated with the Level of Care system used to reimburse contractors of 24-hour care (including child placing agencies and residential treatment centers):

- The methodology used to set rates is based upon a number of untested assumptions and assumes that the type, amount, and quality of care provided from one child to the next is uniform within each Level of Care and among contractors.
- Certain categories of costs are excluded from the rate-setting process without empirical justification.
- Cost reports used during the rate-setting process do not directly capture costs by individual Level of Care.
- The accuracy of the cost report data used in the rate-setting process is questionable since there is limited audit coverage of these cost reports, and cost report training is not mandatory for contractors.

During our project we found that, although DPRS formed a rate-setting task force and a number of modifications to the process have been discussed, *the rate-setting methodology remains unchanged since the September 1994 State Auditor's Office report.*

During the time since DPRS separated from DHS, DHS has performed rate-setting tasks on behalf of DPRS through an interagency agreement. (See the description of DHS' rate-setting process in Section 6.) This agreement was not renewed this year, and, as a result, starting at the end of December 1995, the rate-setting task must be performed by DPRS staff who are not experienced in performing these tasks. The following are concerns over DPRS' efforts to modify the existing rate-setting methodology:

- Although DPRS has collected contractor time study data which would help to refine the rate-setting methodology, this data has not yet been factored into the rate setting.

- The format of the 1994 cost reports required of contractors was modified in order to fit a proposed rate-setting methodology existing in February 1995. However, the February 1995 proposed rate-setting methodology was never adopted. Consideration has also been given at DPRS to not requiring contractors to submit 1995 cost reports. This would be detrimental to DPRS for the following reasons:
 - If DPRS implemented a revised rate-setting methodology and no cost report data had been collected, they would not be able to use the revised methodology.
 - If there are no 1995 cost reports, there will be no cost report field audits or desk reviews. These field audits and desk reviews are the primary auditing tools currently in use to monitor 24-hour care contractors. If contractors are not required to submit 1995 cost reports, their knowledge, education, and training on cost report preparation will suffer.
 - If there are no 1995 cost reports, DPRS will have no cost report data base from which to perform a risk analysis and begin contractor financial reviews.

Additionally, it should be noted that a rider to the General Appropriations Act, 74th Legislature, R.S., requires DPRS to examine the reimbursement methodology for Foster Care payments and determine the extent to which the methodology and the rates established under the methodology cover the median cost of allowable services. Another rider specifies that DPRS may not reduce Foster Care rates during the 1996-1997 biennium.

Section 7-B:

Contract Provisions, Financial Monitoring, and Budget Approval for Cost-Reimbursement Contracts Is Not Sufficient to Ensure Contractor Accountability

DPRS' cost-reimbursement contracts do not always include contract provisions which hold contractors accountable for how contract funds are spent. Many contract budgets are set regionally with only limited guidance provided by agency headquarters in Austin. Further, the adequacy of DPRS' financial monitoring of cost-reimbursement contracts varies significantly between the types of contracts.

Contracts do not consistently contain provisions which hold contractors accountable for how contract funds are spent. Cost-reimbursement contracts for all of the programs reviewed did not include provisions which clearly specify allowable and unallowable costs or contractor financial reporting requirements. As the contractor is reimbursed for actual costs incurred, it is essential that contract provisions limit contractor expenditures to those reasonable and necessary for the operation of the program. In addition, most of the contracts reviewed contained no provisions requiring contractors to submit an annual audit report prepared by a certified public accountant. This requirement is usually standard for cost-reimbursement contracts.

Many contract budgets are set regionally with only limited guidance provided or standardization imposed by DPRS headquarters in Austin. DPRS' process for establishing budgets for cost-reimbursement contracts is not sufficient to ensure that the contract reflects the reasonable and necessary costs of providing services. The budgets for adoption brokers, in-home casework and case management, and preparation for adult living contracts are set regionally with only limited guidance provided by staff at DPRS headquarters. Although it is important to allow the regions a certain amount of flexibility in setting budgets so that differences in geography and demographics can be recognized, without providing some standard guidelines regarding the maximum amounts which should be paid for services, DPRS cannot be assured that it is paying the most reasonable amount for these services.

For example, DPRS has designated its own staff to serve as coordinators of the agency's Preparation for Adult Living (PAL) Program. DPRS also contracts to provide services such as training in association with this program. Therefore, the operation of this program is a joint effort on the part of the DPRS' PAL coordinator and the contractor providing the services comprising this program. In reviewing one PAL contract, we found that one of the agency's PAL coordinators would routinely send letters to the PAL contractor requesting that a variety of payments be made for miscellaneous goods or services that individuals such as foster parents or trainers had provided in association with the PAL program.

The goods and services were items such as airline tickets for trainers who provided PAL training, books and tuition for PAL program participants, and videos used in a PAL training session. Maximum allowable rates for these goods or services were not specified in the PAL contract. The letters sent by the agency's PAL coordinator to the contractor for reimbursement were not always accompanied by attached receipts or invoices to support the costs of the goods or services for which reimbursement was requested. The contractor felt obligated to make these payments, however, as the request for payment was coming directly from DPRS itself. We identified this issue as an additional weakness in the agency's internal controls.

The manner in which the agency's regional offices are allocated funds for contracting from the agency's legislative appropriations also impacts the establishment of contractor budgets. After legislative appropriations are made to DPRS, the total amount of funding available for each program is determined. Funds are then allocated for each individual program to each of the 11 regional offices based upon a different formula for each program. Uncertainty about the regional funding formulas may make planning and budgeting more difficult.

The adequacy of the agency's financial monitoring of cost-reimbursement contracts varies based upon the contract type. DPRS does not routinely monitor the financial records of cost-reimbursement contractors to determine appropriate use of funds. DPRS conducts an annual financial review of the services to Runaways and At-Risk Youth contractors. Although this review is not comparable to a full financial review of expenditures, it does include testing of a small number of salary, fringe benefit, travel, equipment, supply, and other expenditures.

On the other hand, in the case of other contracts such as In-Home Casework and Case Management contracts, Post Adoption contracts, PAL contracts, and Guardianship contracts, the extent of financial monitoring conducted is solely dependent upon the actions which may (or may not) be taken by DPRS regional staff to monitor the financial aspects of the contract. In other words, in the case of these contracts, there is no standardized statewide financial monitoring system in place.

Section 7-C:

DPRS' Procedures for Awarding Contracts Should Be Improved to Better Ensure That the Best Contractors Are Objectively Selected

DPRS' contractor selection procedures do not ensure that the most qualified contractors are always selected. The process used to select the contractors varies significantly depending upon the type of contract.

Selection of contractors through an enrollment process diminishes competition among contractors for obtaining initial contracts. The use of an open enrollment process limits DPRS' ability to objectively select the most qualified and efficient contractors. Contracts for Child Placing Agency and Residential Treatment Center services are awarded contracts through the use of an enrollment process. The enrollment process requires that a potential contractor obtain a Child Placing Agency license or a Residential Treatment Center license and meet the Level of Care standards applicable to the level(s) of children that the potential contractor wishes to serve. Specifically, the potential contractor must first obtain a license through DPRS' Licensing Division, and the potential contractor is then subject to a Level of Care standards review by Youth for Tomorrow, a private contractor hired by DPRS to perform these types of reviews.

During the enrollment process, the potential contractor coordinates with an Institutional Placement Coordinator in the nearest DPRS regional office. Once the license is obtained and the Level of Care standards have been verified, a contract is initiated at the DPRS regional office and subsequently approved at DPRS headquarters in Austin. We verified that the enrollment requirements were met for a sample of Child Placing Agency contractors and Residential Treatment Center contractors, and we found no discrepancies.

According to DPRS officials, the process of selecting contractors through an enrollment process originated during a time in which the number of potential contractors was relatively low, and, consequently, it was believed that a competitive bidding process was not feasible. As reimbursement rates have increased in recent years, the number of potential contractors has also increased. However, DPRS continues to select contractors through the enrollment process.

DPRS has chosen to use the increased number of contractors as leverage in becoming more selective about the contractors with which it will place children. It is important to note that simply having a Child Placing Agency contract or a Residential Treatment

Center contract with DPRS does not guarantee that DPRS will place any children with that contractor or that the contractor will receive any payment from DPRS. In summary, in response to the increased number of potential contractors in recent years, DPRS has chosen not to change to a competitive bid process for contracts, but, rather, to become more selective about the contractors with which it places children.

DPRS' board has made recent changes to the rules governing the enrollment process which will enable DPRS to be somewhat more selective in contracting for 24-hour care. These rule changes will afford agency staff greater latitude in rejecting potential contractors through the enrollment process. The rule changes require the Office of Protective Services for Families and Children to inspect and approve the potential contractor's physical facilities and operations and assess the usable space and equipment, proximity, and access to needed resources and services and the potential contractor's capacity to protect the health and safety of children in its care.

Contractors for certain types of contracts are informally selected by DPRS with no competitive procedures, while other types of contracts are awarded regionally through competitive procurement processes which are not standardized across DPRS regional offices.

- **Adult Guardianship and Adoption Broker Contracts** - Traditional competitive procurement procedures are not used to select the Adult Guardianship and Adoption Broker contractors. In the case of the Adult Guardianship contract reviewed, DPRS attempted to informally locate contractors who were willing to provide this service. However, according to DPRS officials, very few contractors were willing to provide this service, and DPRS eventually had to contract with the few contractors who agreed to provide the service.

Although DPRS is currently considering conducting a competitive procurement for this service, certain barriers to this type of procurement process exist. Once a legal guardian is appointed for an individual, this guardian is appointed for the individual's lifetime, and this would obviously conflict with a competitive procurement cycle in which new contractors could potentially be selected every few years. On the other hand, it should be recognized that, in contracting with only a few contractors, DPRS is also running the risk that, if those contractors fail to perform, the viability of the guardianship function itself could be at risk.

The Adoption Broker contract was developed at one of DPRS' regional offices in response to a perceived problem involving DPRS' ability to contract with adoption agencies in a timely manner. (Although in effect during the period being audited, it should be noted that this contract is no longer in use.) Through the Adoption Broker contract, DPRS' regional office designated a contractor to act as a reimbursing agency for the adoption agencies through which DPRS placed children.

At the time this broker contract was developed, the DPRS regional office felt this contract was necessary because it was taking too long for DPRS to contract directly with adoption agencies. Through the broker contract process, DPRS only

had to contract with a single reimbursing agency, which, in turn, would contract with numerous adoption agencies. The particular contractor with which the DPRS regional office chose to enter into the broker contract was chosen based upon the fact that the regional office had done business with this contractor in the past and felt it could provide the service. No competitive selection procedures were used.

Although this contract is no longer in use, the need for this type of contract sheds light upon contracting inefficiencies at DPRS, and it serves to illustrate the autonomy of DPRS' regional offices in the contracting process. It also demonstrates a situation in which competitive procurement procedures could have been, but were not, used.

- **In-Home Casework and Case Management and Preparation For Adult Living Contracts** - The In-Home Casework and Case Management and Preparation for Adult Living contractors were selected through a competitive procurement process which varied depending upon which of DPRS' regional offices awarded the contract. For each of these contracts, the DPRS regional office is responsible for developing its own Request for Proposal (RFP), soliciting bids, evaluating bids, and selecting contractors. Without a standardized process for contractor evaluation and selection, there is no assurance that the best contractors have been fairly and objectively selected.

Two issues were presented in a September 1994 State Auditor's Office report titled *A Review of Management Controls at the Texas Department of Protective and Regulatory Services* (SAO Report No. 95-003). This report stated that each region's contracting function operates independently and is not required to follow a statewide process. In addition, this report indicated that regional contract managers are self-trained on the job through the use of the *Contract Administration Handbook*, and that, without centralized oversight of contract personnel, there is an inability to detect or correct inaccurate or inconsistent contract practices. During this review, we concluded that these conditions still existed.

- **Post Adoption Services and Services to Runaways and At-Risk Youth Contracts** - The Post Adoption Services and Services to Runaways and At-Risk Youth contractors were selected through competitive procurement procedures which were managed by staff at DPRS headquarters in Austin. In the case of Post Adoption services, headquarters issued the RFP and evaluated bids, and the bid evaluations were then sent to the various DPRS regional offices for final contractor selection and negotiation. We reviewed the procurement procedures used to select contractors for Post Adoption Services during fiscal year 1994 and found that this process appeared to result in an unbiased selection of contractors. We found that the RFP provided clear specifications, all qualified proposals were scored consistently, and that proposals which did not meet the minimum qualifications were not considered. No weaknesses in this contractor selection process were identified.

We also reviewed the February 1995 procurement procedures used to select contractors for Services to Runaways and At-Risk Youth contractors. We found that, in general, this process appeared to result in an unbiased selection of contractors, that the RFP provided clear specifications, and that all qualified proposals were scored consistently.

Recommendations:

We commend DPRS' efforts to form a new Contracts Office and implement a formal system for monitoring the financial aspects of its contractors. DPRS should ensure that this office implements a process which includes the elements of a contractor risk assessment procedure to select contractors for review, periodic on-site reviews of the financial records of high-risk contractors, and follow-up procedures to ensure the financial issues identified at contractors have been resolved.

In addition, we acknowledge that the enrollment process allows DPRS to contract with a wide variety of contractors in various geographical areas of the State and that this process also allows DPRS to have more selection among the contractors with which DPRS will place children. However, as this selection process does not provide for a high level of competition among contractors for initial contracts, it also results in a relatively high number of contracts which must be approved and monitored.

We recommend the following:

- Take action to promptly comply with the legislative requirement to examine rate-setting methodology. Efforts in this area should include work to address and correct the known weaknesses in the current rate-setting methodology. DPRS should also establish a time frame within which this methodology will be revised.
- Continue to require all contractors for 24-hour care services to submit cost reports annually, but make attendance at cost report training mandatory for all contractors. If cost reports continue to be used as a basis for establishing unit rates, methods to verify the accuracy of provider-reported cost data should be strengthened. The number of field audits should be sufficient to provide reasonable assurance that the reported costs are accurate. Stronger sanctions should be developed and implemented for reporting false data on cost reports. In addition, cost report training should be mandatory for all programs.
- Review and amend each contract type to ensure that the contracts contain clear provisions which set forth the definitions of allowable and unallowable costs under the contract. Additionally, DPRS should review and amend its contracts to ensure that the contracts contain adequate provisions describing the process by which funds spent on unallowable costs will be refunded to DPRS.

- Add provisions to the Child Placing Agency contracts which ensure that DPRS is in compliance with all regulations regarding the amount of the daily unit rate a Child Placing Agency may retain prior to paying the actual foster care home.
- Given the increased number of potential contractors which did not exist when DPRS initially began using the enrollment process, the agency should perform an analysis to determine whether 24-hour care contractors should continue to be selected through an enrollment process, or whether a selection process involving the submission of competitive bids should be implemented.
- Enhance the guidance regarding contractor selection procedures provided to regional offices. For example, guidance should encompass things such as maximum recommended payment rates for contracted services, the necessary elements of an RFP and a competitive contractor selection process, and centralized contracting training sessions through which regional office staff could obtain formal instruction regarding the contracting process.
- Whenever possible, strive to contract with potential contractors through competitive procurement procedures. Reasons for not awarding contracts through a competitive process should be thoroughly documented and approved by DPRS headquarters staff.

Section 8:

The Department of Health's Contractor Selection, Financial Monitoring, and Budget Approval Processes Require Strengthening to Ensure Contractor Accountability

Current processes used by TDH to award contracts, establish rates and contract budgets, and monitor financial performance do not consistently ensure that:

- only reasonable and necessary costs are charged to the contract
- contractor compensation (contract rates and budget amounts) is aligned with the cost to provide services
- the best contractor is objectively selected

However, we did find that cost-reimbursement contract provisions are generally designed to hold contractors accountable for spending public funds appropriately. We reviewed eight TDH providers whose contracts totaled over \$10.2 million. Figure 7 (on the following page) shows the programs included in our review and a summary of the selection and rate-setting methodology for each:

Figure 7

Summary of TDH Contracts Reviewed

Program	Contractor Selection	Payment Methodology
<p>HIV/AIDS Ryan White/Title II CARE Grant; Housing Opportunities for People with AIDS (HOPWA); State Services Grant</p>	<p>Selection for these programs generally entails a two-step process:</p> <p>First, TDH contracts with 26 administrative agencies (one in each of the 26 HIV Service Delivery Areas throughout the State) who are selected by a consortia of local organizations and individuals. Each consortia selects an administrative agency using its own locally developed criteria.</p> <p>Second, administrative agencies use a competitive bid process to select subcontractors and award contracts. (Administrative agencies can also provide services and may contract for those services they do not provide.)</p>	<p>TDH allocates total grant funds for these programs to the administrative agencies using a formula which considers total AIDS cases, area population, and estimates of persons living in poverty.</p> <p>All HIV contracts are cost-reimbursement.</p>
<p>HIV/AIDS Early Intervention Program (EIP); Education</p>	<p>Competitive bid process.</p>	<p>Contracts are cost-reimbursement with a maximum contract amount. Maximum amount is awarded based on proposed budget, amount of funding available, and whether the project plan is reasonable.</p>
<p>Maternal Child Health Care (Title V)</p>	<p>Competitive bid process, but Requests for Proposals are sent only to current contractors.</p>	<p>Cost-reimbursement until FY 1995; now, fee-for-service. Fees based on Medicaid rates.</p>
<p>Family Planning (Title X)</p>	<p>Current providers generally renewed after submitting an application; new providers selected using a competitive bid process.</p>	<p>Cost-reimbursement.</p>
<p>Family Planning (Title XX)</p>	<p>Current providers generally renewed after submitting an application.</p>	<p>Fee-for-service; fees based on Medicaid rates.</p>

Figure 7 (concluded)

Program	Contractor Selection	Payment Methodology
Medical Transportation	Competitive bid process.	Unit-rate negotiated between TDH and contractor based on budget and estimated regional need for services.
Women, Infants, and Children (WIC) Nutrition Program	Existing contracts automatically renewed; new contractors are informally selected.	<p>Cost-reimbursement up to a maximum amount. The maximum amount is calculated using unit rates for seven levels of providers.</p> <p>(Rate scales are based on provider salaries, rent, and benefits. Rate tables were developed in approximately 1978 with adjustments to tables and additional scales developed over time. Providers are assigned to one of the seven rate scales based on provider salaries, population density, number of clinics, and the size of the provider.)</p>

Section 8-A:

Contract Budget Approval and Contractor Selection for Cost-Reimbursement Contracts Should Be Strengthened

While contract provisions used by TDH generally hold contractors accountable for how they spend contract funds, TDH's process for evaluating proposed budgets for cost-reimbursement contracts is not sufficient to ensure that maximum contract amounts reflect only the reasonable and necessary costs to provide services. Our review of TDH service providers identified \$297,294 in questioned costs for the cost-reimbursement contracts reviewed. For purposes of this report, questioned costs include costs which are either:

- not reasonable and necessary to the program objectives
- are specifically disallowed by state or federal guidelines
- do not conform to requirements or limitations set forth in the conditions of the contract award

Furthermore, the competitive processes used to select providers do not always ensure that the best contractor receives the award. During the period of our review, TDH's HIV/AIDS, Title X (Family Planning), and Title V (Maternal Child Health Care) programs used cost-reimbursement contracts.

Contracts Include Many of the Provisions Necessary to Ensure Contractor Accountability. Cost-reimbursement contracts for the programs reviewed include the provisions necessary to hold contractors accountable for the appropriate use of public funds. TDH has developed a general contract which contains sufficient provisions for financial reporting and monitoring. Each program tailors the general contract to meet

its needs, and none of the programs tested weakened the provisions of the general contract. The general contract requires:

- providers to submit routine financial reports
- contractors receiving \$25,000 or more in total federal/state financial assistance to obtain an agency-wide independent financial and compliance audit
- contract expenditures to comply with federal cost principles for allowability
- providers to refund any funds claimed and received which TDH determines to be ineligible for reimbursement
- providers to develop, implement, and maintain financial management and control systems that meet or exceed the requirements stipulated by the Uniform Grants and Contract Management Act

Although these general provisions are only intended to apply to cost-reimbursement contracts, we found that TDH included the same provisions in the Family Planning (Title XX) contract, which reimburses contractors a fixed rate on a "fee-for-service basis." However, during our review of a Title XX provider, we found that TDH personnel had told the provider verbally that it was not required to adhere to the contract provisions. Once a contract has been signed and executed by both parties, any changes to the requirements should be made with a written contract amendment.

TDH Does Not Have A Formal Process for Determining the Reasonableness of Contractor Budgets. Evaluation of budgets proposed by contractors is not adequate to ensure that the final and approved budget reflects a fair and reasonable amount for the purchased services. As cost-reimbursement contracts provide little incentive to spend less than the maximum specified in the contract, it is essential that the final budget reflect the most appropriate use of state funds. We found the following weaknesses in processes used to establish the final approved budgets:

- The HIV Bureau reviews proposed budgets for reasonableness based only on experience with other providers. Ranges of acceptable costs by category have not been developed, and no documentation that determines the costs to provide services is maintained. In fact, during our review of providers' proposed budgets, we found three instances in which contractors received more funding than they requested:
 - One provider requested \$25,675 in HIV/AIDS Early Intervention Projects (EIP) funds but was awarded \$37,553 (46 percent more than was requested).
 - Another EIP provider requested \$21,336 but was awarded \$31,336 (47 percent more than was requested).
 - One HIV/AIDS State Education provider requested \$36,078 but was awarded \$43,471 (20 percent more than was requested).
- Title X (Family Planning) budgets are reviewed for reasonableness; however, there are no written guidelines on what is reasonable. In reality, maximum contract amounts are set regionally based on the availability of funds.

Without thorough analysis of proposed budgets, TDH does not have adequate assurances that maximum contract amounts are based on the most appropriate or cost-effective use of public funds.

Current Fiscal Oversight Process Should Be Strengthened To Allow Follow-Up Opportunities in Areas of High Risk. In order to ensure that contractors use state funds in accordance with the terms of the contract, the Grants Management Division performs at least biennial fiscal reviews of providers who receive \$25,000 or more per year from state and federal sources at least once every two years. The fiscal reviews include the following:

- completing an internal control questionnaire
- reconciling reported expenditures for a given quarter to provider records
- testing expenditures and supporting documentation for one month

During their review, monitors select one month from a sample quarter to trace expenditures to quarterly budget reports and supporting documentation. If questioned costs are identified in the sample, TDH either requests reimbursement for the questioned amount or withholds that amount from future reimbursements. *However, additional months are not routinely tested to ensure that similar expenditures were not made and claimed in other months.*

All eight of the TDH providers we reviewed had been reviewed by TDH prior to our audit. However, our review of providers still found instances of potential questioned costs and weaknesses in providers' systems of internal controls not identified by the TDH audits. For example:

- We reviewed one HIV/AIDS provider and found \$102,299 in questioned costs. Examples of the questioned costs include:
 - Payments of \$7,923 made to a related party for purchases of equipment made without the benefit of a competitive procurement process and questionable telephone repair services such as turning the phone ringer on and plugging a power cord into the wall.
 - \$10,000 in purchases made on the last day of the contract. The items purchased were not disbursed to clients during the contract period.
 - \$1,780 in expenditures which were overallocated to TDH and \$3,115 in payments made without the documentation required by program standards.
- At another HIV/AIDS provider, we found over \$5,400 of expenditures which were made without obtaining the documentation required by the contract.

Although the financial reviews provide some assurance that funds are used appropriately, limiting the reviews prevents monitors from detecting additional instances of inappropriate expenditures.

Competitive Processes Used to Select Cost-Reimbursement Contract Providers Do Not Ensure that the Best Contractor Receives the Award. The current processes used by TDH to award its cost-reimbursement contracts do not ensure that the best contractor is fairly and objectively selected. For contracts which are competitively awarded, the effectiveness of the competitive process is hindered by awarding contracts to other than the highest ranked bidder and by the lack of clear criteria for proposal evaluation. Other programs limit competition to existing contractors. Contract renewals for these programs are based solely on a review of provider applications for continued funding.

TDH uses competitive bidding to select contractors for the HIV/AIDS Early Intervention Projects (EIP) and Education Grants Programs. The criteria used to evaluate potential contractors are included in the Request for Proposal (RFP), and an evaluation instrument with points for each criterion is developed for raters to use in scoring the proposals. Two internal and two external reviewers as well as regional staff use the evaluation instrument to score the proposals. A combined average score is calculated for each proposal and is to be used to select the provider for contract award.

However, the proposal with the highest combined average score in a region or city is not always the provider selected. For example, in our review of awards of EIP and Education Grant funds, we found:

- In 5 of the 8 groupings of providers by region, EIP contract awards were made to providers who did not have one of the grouping's highest combined average scores.
- Three EIP applicants from one regional provider grouping had higher average scores than 6 of the 9 providers who were ultimately awarded contracts. (Two of these three providers were awarded one-time funding, however.)
- For the Minority Education awards, 2 of the 13 applicants from a major metropolitan city received contracts. Three applicants from this same city did not receive funding but had higher average scores than one or both of the providers who received contracts.

Additionally, raters' scores of provider proposals vary considerably. For example, for the nine providers who received EIP contracts, low and high scores varied by as much as 46 points (of 110 points maximum). This suggests that the evaluation instrument's criteria are not clearly defined. TDH does not train evaluators on the use of the instrument and relies on the reported expertise of the external raters to ensure understanding of the evaluation instrument.

In some cases, TDH limits competition to current providers. By limiting competition to current providers, TDH does not have adequate assurances that the best contractor is selected to provide the services. During fiscal year 1994, competition for the Maternal Child Health Care (Title V) programs was limited to current providers. RFPs were sent only to existing providers. Family Planning (Title X) contracts are automatically awarded to existing contractors (unless there are significant unresolved

problems). New providers are solicited only if additional funds become available during the year. Beginning in fiscal year 1996, TDH plans to open competition for Title V and Title X funding to all parties interested in providing the services.

Section 8-B:

Controls Over Unit-Rate Contracts Do Not Prevent the Inefficient Use of Public Funds

Current controls over unit-rate contracts are not adequate to ensure the appropriate and effective use of public funds. Unit-rate contracts reimburse the contractor a fixed rate for each unit of service delivered without respect to the actual costs of providing the services. Instead of monitoring the appropriateness of provider's expenditures made under unit-rate contracts, TDH relies on developing contract rates which reasonably align with providers' costs to provide services to ensure that its contracting dollars purchase the most possible services. However, current processes for developing these rates are not adequately controlled or documented to ensure rates align with costs. Additionally, although some programs will use competitive bidding to award future contracts, competition for past unit-rate contract awards has been limited.

Provider expenditures made under unit-rate contracts are not monitored. TDH does not typically test expenditures to determine the reasonableness and allowability of expenses for unit-rate contracts. The only financial aspect of unit-rate contracts reviewed by TDH is provider billings. The Grants Management Division selects a sample of client files to review documented services against provider billings for the Title V and Title XX programs. Although regional managers monitor Medical Transportation providers, the monitoring focuses on how well providers maintain financial and programmatic records, not on how providers spend their funds.

Because the WIC Program reimburses actual expenses up to a maximum amount calculated using predetermined unit rates, the WIC Program does review selected provider expenditures. WIC has its own monitoring division (separate from Grants Management) which is responsible for financial, compliance, and performance monitoring of WIC providers. WIC monitors conduct biannual on-site reviews of providers in which they:

- Check for compliance with program policies (as required by WIC regulations).
- Determine that costs associated with the program are allowable and that prior approval was obtained for certain expenditures.
- Review enrollment records to determine that reimbursed funds were calculated accurately.

We reviewed one WIC provider and found no material questioned costs. However, because the unit rates developed for WIC contracts are subjectively determined, TDH still does not have adequate assurance that providers are reimbursed only for reasonable and necessary costs.

Rates do not align with costs to provide services. TDH has not developed its rates using formal methodologies which ensure contract compensation does not exceed the reasonable and necessary costs to provide services. Because expenditures made under unit-rate contracts are not subject to the same controls that expenditures made under cost-reimbursement contracts are, strong controls over the process used to develop unit rates are critical to ensure providers receive only fair and reasonable compensation to provide services. However, TDH's rate-setting processes do not provide these assurances. Specifically:

- WIC providers are reimbursed actual costs up to a maximum amount as calculated using predetermined unit rates. However, the unit rates which serve as "caps" on provider reimbursements have not been systematically calculated based only on necessary costs to provide services. Instead, the unit rates have evolved over time. According to TDH management, initial rates were established based on historical provider expenditures, but there is no documentation of the actual methodology used to develop these rates. Additionally, there are no written procedures on changing the rate scales, and there is no documentation showing how and when rates were increased in the past.
- Fee-for-service amounts for Title V (beginning in 1995) and Title XX programs are based on Medicaid rates. However, for some services, the Title V and Title XX fee-for-service rate differs from the Medicaid rate, and this variation is not based on a cost analysis.
 - Title XX rates have not increased with increases in Medicaid rates. Title XX rates for new services (services not included in the Medicaid rates) are determined by analyzing the costs to provide that service. TDH determines the fair market cost of any products used in delivering the service, plus a subjective "mark-up." The labor costs to deliver the services is determined by surveying providers to obtain a cost estimate. The estimated product cost and labor cost are combined to obtain the unit rate for these services.
 - Title V rates are based on Medicaid, with the exception of services which include outreach and case management activities. Since Medicaid does not allow for outreach and case management services, the Title V rates for procedures which include these services have been increased by 50 percent for prenatal and child health visits and by 25 percent for all other services. These increases are not based on analysis of the costs to provide these services, but have been subjectively determined. Therefore, it is difficult to ensure that these rates align with the cost to provide services.

Competition for awarding some programs' contracts is limited, and the results of proposal evaluations are not always adequately documented. Because TDH is trying to expand the number of current WIC providers, contracts with existing WIC providers are automatically renewed (barring performance problems). New WIC contracts are awarded to providers that submit applications that meet federal criteria for service providers. In the past, TDH has not adequately documented its review of provider applications. The procedures and criteria for evaluating contractors' proposals

are also not documented. As a result, TDH does not have adequate assurances that only qualified providers are awarded contracts. Additionally, should the personnel who currently review provider applications leave the agency, new personnel would not have the necessary information to fairly and consistently review applications.

According to TDH management, provider proposals are reviewed by the WIC Bureau Chief and four department directors who evaluate:

- whether the provider would be financially viable in six months by serving the proposed number of clients in its area
- the quality of personnel employed to provide services
- the provider's ability to provide related health services
- any findings from past reviews (for existing providers)

However, because TDH does not maintain files on its selection process, we could not verify that TDH's process fairly selects the best contractor for WIC services.

Medical Transportation contracts are competitively awarded every four years. Proposals are evaluated against criteria set forth in the RFP by a panel of regional personnel. However, the scoring sheets for evaluating the proposals do not contain guidelines to assist the review panel in scoring proposals.

Title XX (Family Planning) providers are automatically renewed (unless there are unresolved problems) without the benefit of competition. When additional funds become available, TDH selects new providers using competitive bidding. However, the only evaluation tool used for evaluating Title XX applicants is a checklist to ensure all required items are submitted. One criteria listed on the application review checklist for Title XX applicants is whether the provider spent all the previous year's dollars. Without clearly defined evaluation criteria, raters may inconsistently evaluate providers, and the most qualified provider may not be selected to receive the contract.

Recommendations:

- Grants Management should expand testing of expenditures when significant amounts of questioned costs or particular categories of questioned costs are found in its one-month sample.
- Negotiation of unit rates should be conducted by individuals experienced in contract negotiation, and rates should be checked for reasonableness prior to final contract award.
- The selection of WIC providers should be documented and should be made against predetermined criteria for award.
- Scoring sheets for all programs which use a competitive award process should be developed which define acceptable and unacceptable levels of performance for

each criterion used to evaluate proposals. Evaluation criteria should be included in the RFP.

- Guidelines for reviewing the reasonableness of proposed budgets for cost-reimbursement type contracts should be developed. Guidelines should include criteria for evaluating proposed administrative and other fixed expenses relative to service costs.
- Contracts should include only those provisions with which providers will be expected to comply. Changes to contract provisions should be documented in writing and signed by both TDH and the provider so that no misunderstandings regarding performance or reporting requirements can occur.
- The methodology and assumptions for developing rates for unit-rate contracts should be documented and formalized.

Section 9:

The Department of Mental Health and Mental Retardation's Contract Administration over Purchased Services Does Not Ensure That the State Receives the Best Value for its Contracting Dollars

Weaknesses in TDMHMR's contract administration of unit-rate contracts, as well as in the calculation of the unit rates themselves, prevent the agency from ensuring that contractors are only compensated for the reasonable and necessary costs of providing services. In addition, the processes used to establish the budgets for the Community Mental Health and Mental Retardation Centers (Community MHMR Centers) and to monitor contractors do not ensure that public funds are used in the most cost-effective manner.

TDMHMR administers several different types of contracts for purchased services, and the agency's contractor selection procedures vary depending upon the type of contract. However, it is important to recognize that TDMHMR is obligated to award certain contracts using specific procedures. We reviewed four TDMHMR providers whose contracts totaled over \$19 million. The types of contracts reviewed during this project, as well as the corresponding contractor selection procedures and payment methodology, are listed in Figure 8.

Figure 8
Summary of TDMHMR Contracts Reviewed

Contract Type	Contractor Selection Procedures	Payment Methodology
Intermediate Care Facility for the Mentally Retarded (ICF-MR)	Contractors are chosen through a contractor enrollment process.	Unit rate per client per day. Unit rates are associated with TDMHMR's Level of Care system.
Home and Community-Based Services	Contractors are chosen through a contractor enrollment process.	There is a single unit rate per client per day.
Community Mental Health and Mental Retardation Performance Contract. (The service system provided under these contracts is negotiated with each contractor. In general, the contractor provides community-based mental health or mental retardation services.)	Health and Safety Code § 534.054 requires TDMHMR to contract with the local mental health or mental retardation authority in each service area, giving preference to the community center located in each service area.	Contract budgets are established based upon an allocation schedule prepared by TDMHMR and through negotiations with the contractors.

Section 9-A:

Weaknesses in Contract Provisions, Financial Monitoring, and Establishment of Unit Rates Limit Contractors' Fiscal Accountability

TDMHMR's unit rate contracts for the Intermediate Care Facilities for the Mentally Retarded (ICF-MR) and Home and Community-Based Services (HCS) do not limit the contractor's use of public funds to the reasonable and necessary costs of providing services. Contracts require providers to deliver the services specified in the contract for a pre-determined rate, but do not contain restrictions over how funds will be spent.

The primary form of fiscal control over unit-rate contractors consists of an annual requirement for the contractor to submit a cost report to be used in the rate-setting process. Although the Texas Administrative Code clearly outlines the definitions of allowable and unallowable costs for the ICF-MR and HCS programs, the requirements only restrict the expenditures which can be included on the cost report, not what the contractor can actually use the funds for. *Consequently, contractors are still allowed to spend public funds on items that may be otherwise considered inappropriate as long as the costs are not included on its cost report.*

Currently, TDMHMR's monitoring efforts focus on compliance with program standards, not the appropriateness of a contractor's expenditures. Both of these aspects are important, but since the contracts do not restrict the use of public funds or require

the reimbursement of funds used inappropriately, monitoring of contractor's expenditures is viewed as unnecessary. During our review of four providers, we found examples of questionable expenditures, such as purchase of gifts and entertainment, payments for company picnics, and employees' use of cellular phones, which would not have been permitted if the contracts limited actual expenditures according to the criteria specified in the Texas Administrative Code.

Although TDMHMR does not audit provider's expenditures, the agency does have some assurances that the personal funds of ICF-MR residents are properly safeguarded and used appropriately by the service providers. The Office of the Inspector General (OIG) from DHS conducts annual audits of client's trust funds for compliance with state and federal requirements. In addition, the OIG performs manual reviews of the ICF-MR billings to determine that provider billings are in line with the funds received.

Weaknesses in TDMHMR's procedures for calculating unit rates result in contractors receiving compensation which exceeds the reasonable and necessary costs of providing services. The current rate-setting process does not ensure that reimbursement rates for ICF-MR and HCS reasonably align with the costs of providing services. ICF-MR contractors are paid a fixed rate according to the level of service provided to each client. HCS providers are paid a single unit rate per client per day. The rates for both of these contracts are set through methodologies which establish the rates using cost report data submitted annually by contractors.

DHS performs the rate-setting tasks on behalf of TDMHMR for both of these programs through an interagency agreement. This agreement requires TDMHMR's governing board to approve the rates established by DHS. The rates are established using information from cost reports submitted by the service providers. Information from the cost reports are factored into the rate-setting methodology along with inflation factors, wage growth factors, unemployment insurance costs, and workers' compensation costs. Inherent weaknesses in the rate-setting methodology (which are discussed in detail in Sections 1 and 6 of this report) can result in some providers receiving compensation which exceeds the reasonable costs of providing services for the following reasons:

- **All providers are paid the same rate for the same services, regardless of the actual costs of providing the services.** The rates are based on the weighted median costs of all providers, which assumes that half of the providers are paid more than the actual costs of providing services, while the other half are paid less than the costs to provide services. The rates are uniform throughout the State, and there is no differentiation based on geographic area or type of provider (e.g., profit versus non-profit).
- **There is little assurance that the information used to calculate the rates is accurate.** Only 10 to 15 percent of the cost reports for each program receive field audits annually. Although all of remaining cost reports receive a desk review, these reviews are limited in scope and are not comparable to an actual audit of the financial information.

A rider to the General Appropriations Act, 74th Legislature, R.S., requires TDMHMR to examine and amend the rate-setting methodologies for both the ICF-MR and HCS contracts. In response to the rider, TDMHMR has hired an outside consultant to assist with the review of the ICF-MR reimbursement methodology. As part of this work, the consultant is trying to determine a more appropriate level of allowable costs.

Section 9-B:

Budget Determination and Financial Monitoring Procedures For the Community Mental Health and Mental Retardation Performance Contracts Should Be Strengthened to Ensure the Most Efficient Use of Public Funds

Budgets for the Community MHMR Centers are developed by MHMR personnel who are not trained in contract negotiation or financial analysis. As a result, there is no assurance that the contract budgets reflect the reasonable and necessary costs of providing services or the best use of state funds. In addition, TDMHMR does not have a comprehensive process to ensure that the contract budget is based on the reasonable and necessary costs of providing services.

Contract budgets are established based upon the amount of funds appropriated by the Legislature each biennium. The appropriations are allocated to each Community MHMR Center based on historical allocations. Any funding available to the agency after each Community MHMR Center has been allocated its base funding is used for inflation adjustments and/or equalization. In addition, each year, the contractors are required to submit a proposed budget. TDMHMR budget analysts compare the allocation amounts calculated using the equalization formula with the proposed budgets submitted by the contractors and prepare an analysis of any differences. This analysis is then sent to the appropriate contract manager, who negotiates the contract with the contractor. Through this negotiation process, TDMHMR and the contractor agree on the service system to be provided and the contract budget.

In March 1995, TDMHMR's internal auditors issued a report which identified the following weaknesses in the contract budgeting process:

- The agency's funding allocation methodology does not consider the actual cost of providing services or the previous performance of the Community MHMR Center.
- TDMHMR's allocation of funds does not consider funding that the Community MHMR Center should receive from other services such as Medicaid reimbursements.
- Although contract managers are required to analyze financial and budget information regularly, they receive little support from TDMHMR divisions with financial responsibilities, such as Fiscal Services or the Budget Office.
- Contract managers do not receive training in financial analysis.

- Contract managers do not have sufficient information to properly evaluate contractor proposals, and there are no standard criteria established for evaluating these proposals.

TDMHMR needs to strengthen its financial monitoring of the Community Mental Health and Mental Retardation performance contracts. The primary forms of financial monitoring for the Community Mental Health and Mental Retardation performance contracts include a review of contractor expenditure reports and internal audit staff reviews of audit reports prepared by certified public accountants. However, no one routinely reviews the audit reports to analyze the financial results or position of provider operations. Although TDMHMR conducted more extensive fiscal and program monitoring in the past, this effort has been discontinued and replaced with a review of reports submitted by the contractors. As a result, TDMHMR cannot ensure that the funds are used appropriately and efficiently.

We reviewed the financial records of three providers with which TDMHMR contracts and found discrepancies which demonstrate the need for the Department to improve its financial monitoring. These examples include the following:

- All of the providers visited made inappropriate expenditures of contract funds or expenditures which could not be supported by adequate documentation, totaling \$27,420. Examples of these purchases included purchases of items not related to a client's disability, purchase of meals not related to travel, hotel bills in excess of the maximum allowable rate, unsupported petty cash transactions, and an unsupported travel advance.
- The providers visited also had inadequate internal controls. Examples of these weaknesses included the following:
 - failure to control employees' personal use of cellular phones
 - use of provider credit cards for purchase of personal items
 - inadequate documentation of accounting policies and procedures
 - failure to store blank checks in a secure environment
 - inadequate mileage reimbursement policies
 - inadequate controls over fixed assets and vehicle maintenance and repair records
 - inadequate controls over subcontractors
 - inadequate policies and procedure regarding depreciation
 - poor controls over petty cash

Section 9-C:

Legal Restrictions Limit the Use of Competitive Procurement Procedures for the Selection of Contractors

State and federal requirements preclude TDMHMR from using competitive procurement procedures to select service providers. As a result, the agency is not able to select the most qualified and efficient contractors. The Federal Government

mandates the use of an open enrollment process for ICF-MR and HCS contracts. The enrollment process for the ICF-MR program requires that a potential contractor complete an application packet, obtain a license from DHS, and obtain Life Safety Code and Health Survey certifications. The enrollment process for the HCS program requires that a potential contractor complete an application packet, prepare a self-assessment report, and complete required training. We tested whether the enrollment requirements were met for a sample of ICF-MR and HCS contracts; no discrepancies were found.

TDMHMR is required by Health and Safety Code § 534.054 to award Community MHMR Center contracts to a local mental health or mental retardation authority for each service area. In addition, the agency is required to give preference to a community center located in the service area. As a result, the majority of the Community MHMR Centers have had these contracts for many years.

Recommendations:

TDMHMR should consider the following:

- Enhance procedures for monitoring the financial aspects of its contracts. TDMHMR should ensure that these procedures include a risk assessment procedure to select contractors for review, periodic on-site reviews of the financial records of high-risk contractors, and follow-up procedures to ensure the financial issues identified at contractors have been resolved.
- Review and amend each of its contracts to ensure that the contracts contain clear provisions which set forth the definitions of allowable and unallowable costs under the contract. Additionally, TDMHMR should review and amend its contracts to ensure that the contracts contain adequate provisions describing the process by which unallowable expenditure amounts will be refunded to the agency.
- Take action to promptly comply with the legislative requirement to examine rate-setting methodologies for ICF-MR and Home and Community-Based Services contracts. Efforts in this area should also include work to address and correct the known weaknesses in the current rate-setting methodologies.
- Take action to promptly address and correct each of the weaknesses in TDMHMR's contracting process identified by agency internal auditors. As part of this effort, TDMHMR should ensure that contract managers receive formal training in contract negotiation, financial analysis, and contract management. In addition, the funding allocation process should be refined to better reflect the actual cost of providing services, as well as the individual needs of the particular area which the contractor will serve.

Summary of Responses by Affected Agencies

State Auditor Comments on Agency Responses

We requested that each of the four health and human services agencies involved in this review, as well as the Health and Human Services Commission, provide us with responses to this audit report. These four agencies were the Department of Human Services, Department of Protective and Regulatory Services, Department of Health, and Department of Mental Health and Mental Retardation.

The primary purpose of obtaining responses from the agencies involved in the review is to provide these agencies with an opportunity to comment on our recommendations. The complete responses from each agency, as well as State Auditor follow-up comments where necessary, are included immediately following these introductory comments.

Health and Human Services Commission

In its response, the Health and Human Services Commission (HHSC) points out that our report appears to emphasize cost-reimbursement methods over others, but concurs with our conclusion that there is no single method of contracting which is best for all contracted services. The HHSC commissioner contends that “. . . more value can be obtained for state dollars by encouraging agencies to negotiate fair prices whenever possible.” HHSC indicated that our report provides helpful recommendations and that HHSC intends to implement many of these recommendations. The response indicates HHSC is committed to working cooperatively with the agencies it oversees in achieving this goal, and we encourage this joint effort.

Department of Human Services

The response submitted by the Department of Human Services (DHS) indicates that they disagree with many of the statements and recommendations contained in our report. The primary basis of these disagreements appears to be a philosophical difference regarding the method used to establish reimbursement rates. DHS takes exception with the fact that we questioned the appropriateness of provider expenditures by emphasizing the fact that under the current prospective cost-based system, the provider's actual expenditures are not limited. DHS asserts that all providers' expenditures are constrained by the flat-rate methodology, and, to the extent that providers perceive an attractive profit opportunity, they generally strive to contain costs. DHS also takes exception with the fact that we questioned the accuracy of the information used to calculate the reimbursement rates.

We agree that there are some benefits to the use of a unit-rate system of reimbursement. However, we disagree with the logic that a prospective cost-based system inherently contains costs by providing an incentive to earn a profit. If the rate-

setting process cannot ensure a reasonable correlation between the costs of service delivery and the reimbursement rates, contractors will receive "excess" compensation to spend as they choose. The examples of unreasonable and unnecessary uses of public funds cited throughout the report prevent us from concluding that current practices truly provide incentives for cost containment and that the process used to establish the reimbursement rates ensures that the State pays a fair and reasonable rate for the services provided. We have included auditor follow-up responses where appropriate.

Department of Protective and Regulatory Services

The response submitted to us by the Department of Protective and Regulatory Services (DPRS) indicates that DPRS acknowledges the weaknesses in the administration of its contracts and that the agency is in the process of beginning to address our recommendations. DPRS has outlined rather specific plans for addressing each of the weaknesses identified. We believe that successful implementation of the plans outlined by DPRS should help achieve a more effective and efficient system for administering the agency's contracts. We encourage DPRS to continue placing a high priority on implementing these plans.

Texas Department of Health

The response submitted by the Department of Health (TDH) indicates that, while they generally agree with our recommendations, they take exception with the criteria used to question provider's expenditures. Overall, we disagree with TDH's assertion that costs should not be questioned in instances where the provider is not in compliance with specific contract provisions or program regulations. We have included auditor follow-up comments where necessary. TDH's responses also indicate that they are interested in making continued improvements in their contracting system, and we encourage them to continue with these efforts.

Texas Department of Mental Health and Mental Retardation

The response submitted to us by the Texas Department of Mental Health and Mental Retardation (TDMHMR) indicates that TDMHMR generally agrees with the report recommendations. In two specific areas, TDMHMR offers alternative plans for addressing the weaknesses identified. The response also indicates that the agency has already outlined plans for addressing each recommendation and is in the process of implementing changes. We believe that successful implementation of these plans should help achieve a more effective and efficient system for administering the agency's contracts. We encourage TDMHMR to continue placing a high priority on implementing these actions.

management's Responses



TEXAS HEALTH AND HUMAN SERVICES COMMISSION

MICHAEL D. MCKINNEY, M. D.
COMMISSIONER

January 25, 1996

Mr. Larry Alwin
Office of the State Auditor
206E. 9th St.
Austin, Texas 78711-2067

Dear Mr. Alwin,

Thank you for the opportunity to comment on the draft of your report on Contract Administration at Health and Human Service Agencies. I appreciate the thoroughness of your staff in conducting this review, and I agree with most of the report. Our experience is consistent with your assessment that adoption of a single method of contracting for all state services would not be beneficial; different situations warrant different methods of contracting in order to achieve the most value for state funds. Your suggestions for improving accountability and value in the various methods of contracting are very helpful, and I will work with our agencies to implement many of these improvements.

Although your report acknowledges the efficacy of various types of contracting, it seems to emphasize cost-reimbursement methods over others, and I believe more value can be obtained for state dollars by encouraging agencies to negotiate fair prices whenever possible. Competitive processes and negotiating for price encourages contractors to control costs, relieves some of the expensive state burdens associated with rate setting and arguing reasonableness of costs, and allows the state to capitalize on market forces that may lower prices. Cost reimbursement may be the only appropriate contracting method in cases where competition is limited or non-existent, but I believe we should encourage agencies to use competitive processes wherever possible. Your report provides some very helpful recommendations about how to improve the state's effectiveness in negotiating prices and we intend to implement many of them.

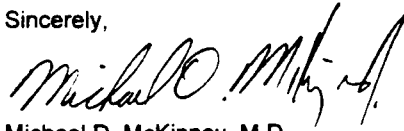
I would like to make a point of clarification about the role of the Health and Human Services Commission in rate setting. As your report acknowledges, we do not set any rates. As single state agency for Medicaid, we approve Medicaid rates set by operating agency boards. For other services, we do not even approve rates. The appropriations bill requires us to recommend maximum rates for residential services, under which agencies must establish their

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own rates. But our statute does not give us any authority to set or approve non-Medicaid rates. We would need to get legislative direction to assume a greater role in the rate-setting process.

Thank you for the opportunity to comment on this report. Your staff has been helpful in our effort to improve contracting across the health and human service agencies, and we look forward to continuing to work with you.

Sincerely,



Michael D. McKinney, M.D.

MM:MH:ls

Texas 
Department
Human^{of} Services

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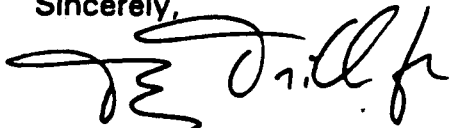
January 31, 1996

Ms. Cynthia L. Reed, Project Manager
Office of the State Auditor
Two Commodore Plaza
206 East Ninth Street, Suite 1900
Austin, TX 78701

Dear Ms. Reed:

We appreciate the efforts of the Office of State Auditor staff in performing this important audit. If you have questions or need to discuss this response please contact Chuck Lyon, Director, Internal Audit, at 438-3350.

Sincerely,



Burton F. Raiford

BFR:cfl

Texas Department of Human Services Responses

The Texas Department of Human Services (the "Department") is committed to effective contract administration on a statewide basis. The Department acknowledges its obligation to ensure that State and federal funds are used wisely and in a manner that provides the highest quality of services and the "best values" to the citizens of Texas. We are accountable to State leadership and the citizens of Texas to constantly maintain and enhance contract administration policies, procedures, practices, and efforts with available resources. Maintenance of rate-setting methodologies and diligence in contract monitoring, including effective auditing of fiscal and service deliverables, are an important part of our core business.

The Office of the State Auditor has raised significant issues in this report. The overall assessment that contract administration practices at health and human services agencies do not consistently ensure that contractors use State funds prudently and in a manner which provides the most benefits to the citizens of Texas concerns us. The Department is and will continue to be proactive and diligent in corrective action to improve this assessment. Our efforts include enhancements to the Department's contract administration infrastructure, including its Contract Council, Contract Administration Handbook, procurement and monitoring functions, and contract specialist and technician training. Audit resources have been focused through risk assessment to work with the program areas in evaluating and enhancing the effectiveness and efficiency of contract administration. Department resources have been committed and used to support fully the Health and Human Services Commission workgroup in developing an overall plan to improve contract administration.

The Department's comments that follow represent our understanding of the basic rate determination issues identified by the Office of the State Auditor, the key points of our response to the issues identified in the report, information regarding the Department's EBT unit rate contract, and responses to specific audit report recommendations.

Basic Rate Determination Issues

The report emphasizes that the uniform statewide ("flat-rate") reimbursement methodologies currently in widespread use by the Department lack mechanisms to ensure that State funds are expended only on reasonable and necessary items. The report notes that, since some providers are for-profit organizations, a profit margin is inherent in the notion of reasonable and necessary costs. However, the report repeatedly emphasizes that "excess" State funds, whether expended on questionable items or not expended at all, are not recouped. Numerous examples illustrate both the fact that related-party mark-ups over cost are widespread and that Department cost reporting rules define these costs as unallowable. The report claims that: "There is little assurance that information used to calculate reimbursement rates is accurate."

Key Points of Department Response

- By focusing on the appropriateness of expenditures rather than the appropriateness of costs included in determining uniform rates, the report indicates a lack of understanding of the different dynamics of a prospective cost-based system, as compared to a retrospective individual cost-settlement system. The former, if properly designed, has strong incentives for overall system cost containment over time, while the latter tends to undermine incentives for cost containment and to encourage spending up to prescribed limits.
- ***See Auditor Follow-Up Comment "A" below.***
- The report focuses on static characteristics of the current system at a point in time, and indicates a lack of understanding of the dynamics of the system over time. In particular, the report indicates no understanding of the role played by profit opportunities as an incentive to constrain spending. By focusing on the appropriateness of individual provider expenditures, the report ignores the fact that all providers' expenditures are constrained by the flat-rate methodology and, to the extent that providers perceive an attractive profit opportunity, they generally do strive to contain costs.

- **Auditor Follow-Up Comment "A"**

As indicated repeatedly in the report, we acknowledge the fact that the current structure of the prospective cost-based system does not limit contractors' actual expenditures or require contractors to reimburse DHS for inappropriate or unnecessary expenditures. However, we focused on the appropriateness of contractor expenditures to determine if public funds are used wisely and in a manner which provides the most cost-effective use of limited state resources. Also, our review included both for-profit and non-profit organizations.

We agree that there are some benefits to the use of a unit-rate system of reimbursement. However, we disagree with the logic that a prospective cost-based system inherently contains costs by providing an incentive to earn a profit. There is no incentive to contain costs reported to DHS on cost reports, which are ultimately used to set rates. If the rate-setting process cannot ensure a reasonable correlation between the costs of service delivery and the reimbursement rates, contractors will receive "excess" compensation to spend as they choose. The examples of unreasonable and unnecessary uses of public funds cited throughout the report prevent us from concluding that current practices truly provide incentives for cost containment.

- The report fails to communicate that related-party mark-ups are, in many cases, merely mechanisms to channel profits from one business entity to another. As long as these mark-ups are excluded from the cost base used to determine rates, there is no reason to assume that rates will not reflect reasonable and necessary costs on this account (because such mark-ups are excluded).

- **Auditor Follow-Up Comment "B"**

The report acknowledges the fact that related party mark-ups are excluded from the cost base used to determine the rates. The report makes the point that even though the related party mark-ups are excluded from the rate-setting process, the provider is not prevented from using public funds to actually pay for the mark-ups.

- The report overstates the claim that there is little assurance that information used to calculate rates is accurate. In many examples, the report confuses inaccuracies which have been corrected and unallowable costs removed from cost reports with costs allowed to remain in the cost report database for rate calculation.

- **Auditor Follow-Up Comment "C"**

The results of our work at both the provider and agency levels supports the conclusion that there is little assurance that information used to calculate rates is accurate. For example, for one provider we reviewed, the DHS desk review process resulted in the removal of over \$200,000 in questioned costs from the provider's cost report. While the correction to the cost report is acknowledged in our audit report, we also point out that the results of our field audit identified an additional \$260,000 in questioned costs.

- The report does not address the costs associated with developing, administering, or managing the changes recommended by the report. Nor does the report address the long-term implications of extensive cost recoupments. Although there are many apparent savings from recouping so-called "excess" funds, the Department's evaluation of this type of system, in light of experience in other states, indicates that the direct administrative costs would be significant and, in the long term, stringent recoupments of unexpended "excess" funds would undermine the cost containment incentives inherent in the current system and significantly reduce any apparent savings. Indeed, the direct administrative costs of extensive recoupments, combined with indirect costs associated with different incentives, ultimately may outweigh any potential savings of recommended changes.

- **Auditor Follow-Up Comment "D"**

As stated in the report, we recognize that provisions which limit contractor compensation and require cost settlements at the end of the year will increase administrative requirements and potentially the cost of contract administration. However, rather than adding additional layers of administrative costs, we encourage agency management to re-examine current contracting practices and identify cost-effective methods to enhance controls over contractors' use of public funds. Ultimately, agency management as well as the appropriate oversight bodies must determine the trade-offs between the costs of better controls and allowing what appears to be current undesirable expenditure practices by providers.

- The report is critical of the Department only field auditing 10% of cost reports in each program and concludes that this is inadequate. However, the conclusions in the report are based on a review of only ten providers. With over 1,500 providers in the programs that the report is summarizing, the auditors based their conclusions on a sample of less than 1 percent. It is our understanding the auditors have decided to expand the sample of providers initially reviewed by selecting additional providers; the additional providers from the Department's programs have been selected with an emphasis on providers who have had contract or cost report problems. Unfortunately, this biased sample will preclude the auditors from being able to make any accurate conclusions regarding the overall contract administration issues facing the State. Since a review of "problem" providers will misrepresent the issues and dramatically overstate any potential savings, the administrative decisions based on such conclusions will be ill-advised.

- **Auditor Follow-Up Comment "E"**

The conclusions are based on the review of the providers who were included in this audit. In total, we reviewed 11 providers who were required to submit at least one cost report and found questionable expenditures at all (or 100 percent) of the providers in our sample.

For the next round of audits, we conducted informal risk analyses to select providers. Although we did request information from DHS to be used in the risk analyses, the information was not the sole factor used to select providers for review. Other information used includes:

- total revenue received by each provider
- independent ratio analysis of cost report data
- type of business entity, such as non-profit, for-profit, etc.

It is our contention that some additional financial analysis could help the Department zero in on providers where audits would be productive.

- When discussing the Department's audit efforts of cost reports, the report does not acknowledge audits of central office operations of corporate-owned providers. Findings of central office audits are applied to all providers owned by the corporations. For fiscal year 1996 the Department has scheduled 15 central office operations audits of Nursing Facility and Hospice services. These 15 chains own 393 of the 1,020 nursing home providers in the State.

- **Auditor Follow-Up Comment "F"**

We encourage DHS's efforts to increase the number of audits scheduled during fiscal year 1996. However, our review focused on the results of DHS audits which had been performed, not on events scheduled in the future. In addition, central office audits only cover costs reported by the central office operations, not

the costs associated with the operations of the 393 nursing homes owned by the 15 chains.

- The report erroneously states the Department has not increased the number of cost audits performed each year. The Department, to the contrary, has done just that. For fiscal year 1996, the Department has scheduled field audits of 20% of the Nursing Facility and Hospice providers, 30% of the Day Activity and Health Services providers, 52% of the Emergency Response Services providers, 27% of the Community Services (Family Care and Primary Care), 24% of the Residential Care providers and numerous central office operations audits for these programs. Desk reviews of providers cost reports will be performed on all remaining cost reports.

- **Auditor Follow-Up Comment "G"**

Again, we encourage the Department's efforts to increase the number of audits scheduled during fiscal year 1996. However, we based our conclusions on information pertinent to the programs and providers included in this audit, not on events scheduled in the future.

- The report is extremely critical of the Department's cost report desk review process. The report again omits the results of 661 desk reviews (2,314 hours in fiscal year 1995 that identified and disallowed over \$24 million of provider costs in the ICF-SNP LTC program while 121 field audits (7,865 hours) identified and disallowed almost \$9 million of providers costs in the same program. In the Department's opinion, the desk reviews are very effective and efficient, especially when the results and results per hour of resources used are considered.

- **Auditor Follow-Up Comment "H"**

During our review of adjustments made during the desk review process for eight providers included in our review (includes some TDMHMR providers), we found that DHS had removed costs of \$247,856 on revenues of \$28,354,299. This results in total adjustments of less than one percent of revenues. In addition, our report does not state that the desk reviews are useless, only that they are not as comprehensive as a field audit.

- The report found that controls over information submitted on the cost reports were minimal, and as a result, questions the accuracy of the data used to establish the rates. The Department strongly disagrees. The auditors have apparently summarily dismissed all controls associated with the rule-making process; the entire rate-setting process; OIG desk reviews and field audits; UAR; and LTC-Regulatory (survey and certification). The Department doubts that any provider would describe our controls as "minimal".

- **Auditor Follow-Up Comment "I"**

The report acknowledges that the rate-setting process itself is well-defined and contains many necessary elements such as edit checks, etc. The report also acknowledges the UAR reviews as well as the reviews of program compliance. However, the latter two do not provide controls over information submitted on the cost reports.

- Several references are made to expenditures which were questionable according to the Texas Administrative Code "or federal cost principles." The federal cost principles which are being applied in these audits are not applicable to these programs and are therefore inappropriate to use in determining whether a cost is questionable. For example, interest on borrowed capital is an allowable expense even though the report labels it as questionable.

- **Auditor Follow-Up Comment "J"**

The report repeatedly acknowledges that the contracts do not limit the contractors' expenditures in accordance with the criteria contained in the Texas Administrative Code or federal cost principles. The cited examples describe what we consider to be inappropriate, unreasonable, or inefficient uses of public funds even though the expenditures may not be prohibited by contract provisions or agency regulations. The point is that we believe that there are some excellent expenditure controls included in the Texas Administrative Code or in federal cost principles that should be included in DHS's contracts.

- The concept of reducing the rate for providers who deliver a large volume of service units does not take into account two phenomena. First, in primary home care, the weighted median methodology ensures high-volume providers exert a greater influence in determining uniform rates paid to all providers. To the extent that the costs of these high-volume providers are lower than other providers delivering lower volumes of service, the uniform rates to all providers are lower than they otherwise would be. In this way, the methodology puts pressure on higher-cost providers to become more efficient. Second, under the flat-rate system, reducing rates for high-volume providers would encourage a variety of organizational means to avoid such penalties. The reduced incentives (rewards) for efficient behavior might ultimately cost the State more.

- **Auditor Follow-Up Comment "K"**

The report presents the concept of reducing the rate for providers who deliver a large volume of service units only as one possible alternative method.

Electronic Benefits Transfer (EBT) Unit Rate Contract

The following comments describe the Department's unit rate contract with its EBT vendor. The Department feels this contract is a good example of how a properly executed unit rate contract is a "best value" for the State.

- EBT was a catalog procurement. It specifies a unit rate (per case/per month) of \$2.00 for food stamp, and \$.75 for AFDC clients. This rate was determined by the current issuance costs at the time of the procurement. This is a flat rate and it is in effect for the entire life of the seven year contract. The detailed work involved to determine the rate, plus the use of competitive procurement, and its seven-year lock, provide assurances that the Department is paying a fair and reasonable rate for this service.
- The contract with Transactive is detailed with the expectations for how services are to be provided. The contractual limitations do cover a code of conduct and the separation of Transactive activities from its parent company, and the low unit rate cost, coupled with the cost to develop, implement and maintain an EBT system, provide assurance that the contractors expenditures will only cover necessary costs of providing services. The actual cost for Transactive to develop and establish an EBT system in Texas far exceeds the funds we have paid them on the unit rate. We expect this to continue for the next three years of the contract. Unit rate costs to date are \$7.9 million, while Transactive's costs are estimated to exceed \$50 million, with HUB costs alone over \$28 million.
- The contract with Transactive does contain performance standards, and does include damages which the Department may assess for non-performance. The EBT Contract Management Unit continues to focus its efforts on service delivery and compliance with program standards.

- **Auditor Follow-Up Comment "L"**

We agree that the information presented on the EBT contract provides a good example of how the State can obtain the best value through the use of a unit-rate contract. However, the services obtained under this contract were outside of the scope of the current audit, which was to look at contractors who provide direct services to clients. In addition, as the agency's response indicates, the unit rate for the EBT contract was developed through a competitive procurement process, not from cost reports submitted by the service providers. As a competitive process is not used to award the contracts we reviewed, the process used to develop unit rates for the EBT contract cannot be compared with the rate-setting methodologies described in our report. In fact, we encourage the use of competitive procurement processes as an appropriate mechanism for obtaining the best value for contracting dollars.

The Department's contract administration over the EBT contract was included in a previous report, An Audit on Administration of Contracts for Information System Purchases (SAO Report No. 95-090).

Responses to Specific Audit Report Recommendations

- **Contracts**

- Recommendation: "Review and amend each contract type to ensure that the contracts contain clear provisions which set forth the definitions of allowable and unallowable costs under the contracts..."

Response: Contracts currently specify that the contractors are required to follow the regulations published in the Texas Register and the regulations specify allowable and unallowable expenditures.

- ***Auditor Follow-up Comment***

The regulations published in the Texas Register only apply to the allowability of expenditures which can be reported on the cost report, not to the actual uses of the contract funds.

- Recommendation: "Review and amend each contract type [with]... provisions which require the contractor to reimburse any funds used inefficiently or inappropriately A cost-settlement should be required at the end of the contract term."

Response: This recommendation indicates a lack of understanding of: (a) the current prospective cost-based reimbursement system and (b) administrative costs of retrospective cost-settlement systems. As discussed in the overview, prospective reimbursement systems, if properly designed, have strong incentives for overall system cost containment over time. Retrospective cost-settlement systems tend to undermine incentives for cost containment. Furthermore, the Department's evaluation of retrospective cost-settlement systems indicated that these systems tended to require extensive administrative and legal costs which could easily outweigh any potential savings.

- ***See Auditor Follow-Up Comment "A."***

- **Strengthen reimbursement methodologies**

- Recommendation: "...methods to verify the accuracy of provider-reported cost data should be strengthened. The number of field audits should be sufficient to provide reasonable assurance that the reported costs are accurate."

Response: Ideally, it would be desirable to conduct a field audit of each provider's cost report each year. Somewhat less ideally, the Department could increase the percent and frequency of field audits. However, the State must weight the cost-benefit of these ideals against the additional administrative costs that would be required. The report implied that available

limited resources could be re-allocated to eliminate inefficient practices and that risk assessment be employed. After several years of downsizing and budget reductions (with the resultant focus on higher and higher priority functions), any capacity to "re-allocate" resources more efficiently has become limited. The report fails to identify any "inefficient practices" which currently could be eliminated or re-allocated. A risk assessment procedure to target remaining resources for field audits has been in place for several years. However, risk assessments do not generate additional resources, they merely indicate how best to use existing resources. Any additional administrative funding to perform more extensive audits would require additional legislative appropriations.

- ***See Auditor Follow-Up Comment "D."***

- Recommendation: "...methods to verify the accuracy of provider-reported cost data should be strengthened...Stronger sanctions should be developed and implemented for reporting false data on cost reports."

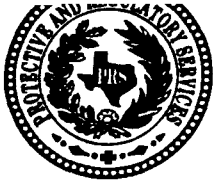
Response: This recommendation indicates a lack of auditor understanding of the current prospective cost-based reimbursement system. Furthermore, the implementation of a sanction system would result in a dramatic increase in administrative costs, in terms of audit, contract, support, fair hearings, and legal staff. The report provides no evidence that the costs of implementing a sanction system of this type could be justified by the potential savings.

- ***See Auditor Follow-Up Comment "A."***

In addition, we contend that an effective sanction system would serve as a deterrent which could ultimately result in reduced audit costs.

- Recommendation: "...methods to verify the accuracy of provider-reported cost data should be strengthened...cost report training should be mandatory."

Response: In recent years the Department has increased the number of training sessions offered each year and enhanced the quality of cost report training offered. These changes have been positively received by providers and staff have noticed improved effort and performance by many providers. Attendance at cost report training has increased each year. In order to further encourage attendance, the Department has implemented a system under which qualified attendees may earn continuing education credits. In addition to cost report training, the Department offers technical assistance to providers. Finally, the Department has proposed rules which would make attendance at cost report training mandatory.



TEXAS DEPARTMENT OF PROTECTIVE AND REGULATORY SERVICES

EXECUTIVE DIRECTOR

James R. Hine

February 5, 1996

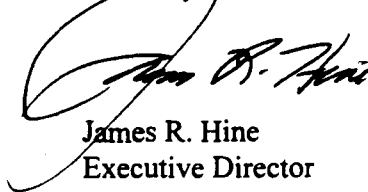
Ms. Cindy Reed
State Auditor's Office
Two Commodore Plaza
206 East Ninth Street
Austin, TX 78701

Dear Ms. Reed:

There is an error in our PRS responses to your report, *Contract Administration at Health and Human Service Agencies (CM-3)*, that needs correction. Our responses indicated on January 25, 1996 the board approved the rate methodology for publication in the Texas Register. In fact, the board discussed the rate methodology on January 25, 1996 in a work session. The approval for publication will not occur until the next board meeting on March 22, 1996. This correction will not affect the ultimate time frame of request for final board approval on May 24, 1996, but the changes are needed for our responses to be factually correct.

Please accept our revised letter which includes the corrected responses for inclusion in your report. We apologize for any inconvenience. Thank you for your assistance.

Sincerely,



James R. Hine
Executive Director

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TEXAS DEPARTMENT OF PROTECTIVE AND REGULATORY SERVICES

EXECUTIVE DIRECTOR

James R. Hine

January 29, 1996

Lawrence F. Alwin, CPA
State Auditor
Two Commodore Plaza
206 East Ninth Street
Austin, Texas 78701

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Maurine Dickey, LMSW-AP
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Dear Mr. Alwin:

Thank you for providing the Department of Protective and Regulatory Services with the opportunity to respond to the draft audit findings contained in your report, *Contract Administration at Health and Human Service Agencies (CM-3)*. Each of the recommendations contained in the report is repeated below, followed by the Department's response in bold type with "General" recommendations addressed first and PRS specific recommendations later. I appreciate the work done by your staff in preparing the report and look forward to your continued assistance in developing a more efficient performance-based system of contract administration.

Contract Administration at Health and Human Services Agencies January 16, 1996, Draft Report

General Recommendations For All Health and Human Services Agencies

State Auditor Recommendation:

"Develop and implement contract provisions to hold all contractors accountable for the appropriate and effective use of State funds." (page 23)

Set specific restrictions in contracts that identify allowable and unallowable costs in a manner similar to federal cost principles.

Establish in contract terms a means of recovering inappropriately used amounts, including a cost-settlement requirement at contract end to facilitate recoupment.

Unit-rate contracts should limit reimbursement to the lower of either the rate or an amount reasonable, necessary and allowable.

701 W. 51ST. • P.O. BOX 149030 • AUSTIN, TEXAS 78714-9030 • (512) 438-4800

Department of Protective and Regulatory Services' Response:

The Department agrees with this recommendation and is in the process of implementing new contract provisions. On January 26, 1996 the board adopted contract rules allowing the Department to renegotiate contracts with 24-hour child care providers through an enrollment process. With the opportunity to renegotiate unit rate contracts, the Department has added contract provisions that identify allowable and unallowable contract costs by reference to the federal cost principles in OMB circulars A-110, A-122 and A-87. The Department's authority to recoup amounts spent for unallowable costs is also included in the new contract. Additionally, the Department is negotiating performance outcomes to be included in the contract. These new provisions will become effective on September 1, 1996. Enforcement of these provisions will ensure that costs relating to unit rate contracts are allowable and reasonable.

All other contracts, except direct agreements with family foster parents, will also include the provisions for allowable and unallowable costs and the Department's authority to recoup unallowable costs. These provisions will become effective on September 1, 1996.

State Auditor Recommendation:

"Develop methods of establishing contractor payments that reflect only the necessary and reasonable costs of providing services." (page 23)

Agencies should identify standard elements of cost and pay similar rates for similar services.

Contractors should adhere to state guidelines, where applicable, which restrict travel reimbursements and other types of expenditures.

Standard rates should reflect reasonable and necessary costs and should be adjusted to accommodate unique provider situations.

Steps should be taken (audit, sanctions, mandatory training) to ensure accurate cost reports.

Department of Protective and Regulatory Services' Response:

The Department acknowledges the potential benefit of standard elements of cost statewide and the establishment of comparable rates for similar services across agencies. We are participating in the review of these issues through committees established by the Health and Human Services Commission and will continue to cooperate in that effort.

The Department recognizes that rates should reflect reasonable and necessary costs. Through PRS riders 14 and 15 of the General Appropriations Act the legislature froze current foster care rates to enable the Department to review the methodology and the rates established by that methodology. PRS is to issue a report to the Health and Human Services Commission, the Legislative Budget Board, and the Governor's Office of Budget and Planning advising them if the current methodology and rates reimburse the median costs of allowable services. From September 1994 until October 1995 a workgroup of providers, provider associations, consultants, and departmental staff met several times to review and amend the reimbursement methodology. Subsequently, the Department incorporated the amendments and presented the methodology to the board for discussion at their work session on January 25, 1996. The methodology will be presented at the March 22, 1996 board meeting for approval to publish the proposed rules in the Texas Register. The Department expects extensive comment and will be presenting the proposed rules to the board on May 24, 1996 for adoption. Following adoption a final report will be issued as required.

State Auditor Recommendation:

"Establish centralized oversight responsibility for contract management of service providers, in particular fiscal monitoring." (page 24)

Review total state funding of providers, not just agency-by-agency totals, to detect double billings.

Coordinate audits with other state agencies to avoid duplication of effort.

Centralize contractor information to allow for analysis of data.

Department of Protective and Regulatory Services' Response:

The Department agrees that some auditing efficiencies would result from an interagency centralized audit function. As previously mentioned, we are participating in committees established by the Health and Human Services Commission and believe that many benefits can be achieved through greater cooperation and information sharing among state agencies. A financial monitoring process built on interagency data and risk assessment is currently being developed as part of the newly assigned responsibilities of the Office of Contract Administration. Audit information from other state agencies will be incorporated into Contract Administration's risk analysis methodology and will be used to prioritize contract auditing tasks. Systematic financial monitoring of purchased services will begin by November 1, 1996.

This payment information will be made available to all state agencies for use in their assessments of contractors and to identify any double billing that may occur.

State Auditor Recommendation:

"Use competitive procurement procedures whenever possible." (page 24)

Department of Protective and Regulatory Services' Response:

The Department agrees with this recommendation. Many PRS contracts are competitively procured. Unit rate services procured through open enrollment are related to the level of care system which is currently being reviewed by the Sunset Commission. The Department will work with the Commission to foster competition in terms of cost and quality. Occasionally, as with the Department's statewide guardianship contract, only one provider is available to provide critically needed services.

State Auditor Recommendations Specific To PRS

State Auditor Recommendation:

"Take action to promptly comply with the legislative requirement to examine rate-setting methodology. Efforts in this area should include work to address and correct the known weaknesses in the current rate-setting methodology. The Department should also establish a time frame within which this methodology will be revised."

Department of Protective and Regulatory Services' Response:

The rate methodology was presented to the board at their work session on January 25, 1996. The rate methodology for 24-hour child care facilities will be brought before the board on March 22, 1996 for approval to publish in the Texas Register. The Department expects extensive comment on the publication. The methodology will be brought before the board for final approval at the board meeting on May 24, 1996.

State Auditor Recommendation:

"Continue to require all contractors for 24-hour care services to submit cost reports annually, but make attendance at cost report training mandatory for all contractors. If cost reports continue to be used as a basis for establishing unit rates, methods to verify the accuracy of provider reported cost data should be strengthened. The number of field audits should be sufficient to provide reasonable assurance that the report data are accurate. Stronger sanctions

should be developed and implemented for reporting false data on cost reports. In addition, cost report training should be mandatory for all programs."

Department of Protective and Regulatory Services' Response:

The Department recognizes the value of accurate cost report data and stronger sanctions as proposed. The rate setting and cost report functions have recently been moved to the Office of Contract Administration. The Department is currently reviewing the functions to improve performance and will incorporate the State Auditor's recommendations to become effective September 1, 1996.

State Auditor Recommendation:

"Review and amend each contract type to ensure that the contracts contain clear provisions which set forth the definitions of allowable and unallowable costs under the contract. Additionally, the Department should review and amend its contracts to ensure that the contracts contain adequate provisions describing the process by which funds spent on unallowable costs will be refunded to the Department."

Department of Protective and Regulatory Services' Response:

The Department agrees with this recommendation and will incorporate provisions requiring all contract expenditures to meet federal cost principals for allowability (Federal OMB Circulars A-110, A-122, and A-87). The new contracts will become effective on September 1, 1996.

In preparation for the new contracts, PRS staff responsible for residential treatment center contracts were trained in January 1996. Federal cost principles of allowability were extensively reviewed during that training. Prior to June 1996 all other PRS contract managers will be trained on federal cost principles. In March and April of 1996, PRS 24-hour child care providers will receive an orientation to the new contract provisions relating to allowability of contract costs. All other contractors who provide purchased services will be educated through distribution of written material prior to June 1996.

All PRS contracts will be amended prior to September 1, 1996 to clearly require providers to refund to PRS any amounts which the Department determines are not allowable under federal cost principles.

State Auditor Recommendation:

"Add provisions to child placing agency contracts which ensure that the Department is in compliance with all regulations regarding the amount of per day unit rate a child placing agency may retain prior to paying the actual foster care home."

Department of Protective and Regulatory Services' Response:

The Board met on January 25, 1996 and discussed the rate methodology including the amount of the per day unit rate a child placing agency may retain prior to paying the actual foster care rate. The methodology will be brought before the board on March 22, 1996 for approval to publish in the Texas Register. On May 24, 1996 the methodology will be brought before the board for final approval. When approved this will be placed in each contract.

State Auditor Recommendation:

"Given the increased number of potential contractors which did not exist when the Department initially began using the enrollment process, the Department should perform an analysis to determine whether 24-hour care contractors should continue to be selected through an enrollment process, or whether a selection process involving the submission of competitive bids should be implemented."

Department of Protective and Regulatory Services' Response:

The Department has begun a review of its procurement methods for 24-hour care and will make every reasonable effort to foster competition, both in terms of cost and quality, among service providers. Given the large number of potential contractors, the Department's selection of contractors should be based on the contractors' documented ability to achieve positive outcomes for PRS clients. The Department plans to work with the Sunset Commission to determine the best competitive process that will accomplish the desired result.

Meanwhile, the Department has continued its efforts to refine outcomes measures by meeting with providers. In February 1996 we will be conducting regional meetings with providers to refine outcome measures and definitions. As part of the enrollment process for 24-hour child care any new measures to be incorporated will be adopted in new contracts to take effect September 1, 1996.

State Auditor Recommendation:

"Enhance the guidance regarding contractor selection procedures provided to regional offices. For example, guidance should encompass things such as maximum recommended payment rates for contracted services, the necessary elements of an RFP and a competitive contractor selection process, and centralized contracting training sessions through which regional office staff could obtain formal instruction regarding the contracting process."

Department of Protective and Regulatory Services' Response:

The Department's regional contract staff need increased support and training to effectively perform their jobs. The PRS Office of Contract Administration was established in November 1995 to provide policy direction and support to regional staff and to develop standard methods for performing contracting functions. The Office has created a central data base containing information on approximately 1,000 agency contracts. In January, the Office provided training to PRS regional contract staff on procedures for procuring 24-hour child care services, risk analysis methods, and the definition of allowable contract expenditures. Additional tasks assigned to the Office of Contract Administration include the following:

- Development of an agency-wide contract risk analysis to be complete by April 1, 1996
- Revision of the Department's Contract Administration Handbook to be complete by May 1, 1996
- Training of regional and state office contract staff will be completed by June 1, 1996
- Administration of financial and performance monitoring of contractors with systematic financial monitoring to begin by November 1, 1996

State Auditor Recommendation:

"Whenever possible, strive to contract with potential contractors through competitive procurement procedures. Reasons for not awarding contracts through a competitive process should be thoroughly documented and approved by staff in Department headquarters."

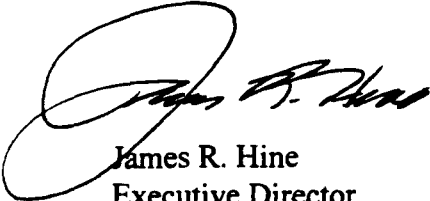
Department of Protective and Regulatory Services' Response:

The Department agrees with this recommendation. Approximately 600 of the 1,000 PRS contracts for purchased services are competitively procured. The remaining contracts, approximately 400, are for 24-hour child care services which are procured through open enrollment. These contracts contain a unit rate which is driven by the level of care system. This level of care system is currently being reviewed by the Sunset Commission. The Department is working with the Commission to make every reasonable effort to foster

competition. Other contracts that are not competitively procured must be reviewed and approved by the Department's Office of Contract Administration in Austin. Five requests for noncompetitive procurements have been approved during this fiscal year. All approved non-competitive procurements were made from organizations that were the only available provider of the service.

Again, thank you for the opportunity of responding to the draft recommendations.

Sincerely,



James R. Hine
Executive Director



Texas Department of Health

David R. Smith, M.D.
Commissioner

Carol S. Daniels
Deputy Commissioner for Programs

Roy L. Hogan
Deputy Commissioner for Administration

1100 West 49th Street
Austin, Texas 78756-3199
(512) 458-7111

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January 29, 1996

Mr. Lawrence F. Alwin, CPA
State Auditor
P.O. Box 12067
Austin, Texas 78701

Dear Mr. Alwin:

On January 16, 1996, your office provided us a draft report entitled *Contract Administration At Health And Human Service Agencies* and requested that we review and provide written comments on the report.

Your office conducted the first audit of contracts in October 1994 and has spent 846 hours on TDH contracts since then. We are pleased with your finding "that TDH's contracts with providers generally include the provisions necessary to hold contractors accountable for spending State funds appropriately."

We are interested, however, in making continued improvements in our contracting system. Since the release of your October 1994 audit report, we have demonstrated our commitment to improving all aspects of contracting for client services. Your office has been kept fully apprised of these initiatives and enhancements that include the following highlights:

1. "Assurance form" for nonprofit Boards.
2. Incorporate explicit sanctions procedures for non-compliance in contracts.
3. Require "letter of good standing" from other State agencies on contractors' performance.
4. A new personal computer server database on contractor performance.
5. Expand risk assessments.
6. Incorporation of performance measures in contracts.

Mr. Lawrence F. Alvin, CPA

Page 2


January 29, 1996

7. Changing the method of contracting for Maternal and Child Health Care (Title V) services from cost reimbursable to fee-for-service at the beginning of fiscal year 1996. Instead of paying the salary costs for certain positions, we now pay for performance in the form of specific outputs. We anticipate this change will result in a 25 percent reduction in cost without a reduction in services. This change, paying for performance, conforms with the recommendations made in the report issued by your office in October 1994, *A Review of Contract Monitoring of Purchased Services*.

Our comments concerning your findings at the Department and comments on the draft recommendations are attached. As we were unaware of the specific findings and observations about the Department until we received the draft report, we could not provide this information earlier. Should you find that time constraints prevent modification of the report to recognize our views, you are requested to include them throughout the report where you discuss the related findings at the Department.

We appreciate the opportunity to submit these comments and look forward to receiving a copy of your final report. If I can be of further assistance, please feel free to call upon me at 458-7353.

Sincerely,


David R. Smith, M.D.
Commissioner of Health

TDH Comments on Findings Concerning Contractor Selection Financial Monitoring and Budget Approval at TDH

Section 8-A: Contract Budget Approval and Contractor Selection for Cost Reimbursement Contracts Should Be Strengthened

We agree that TDH's process for evaluating proposed budgets for cost reimbursement contracts does not insure that maximum contract amounts reflect only reasonable and necessary costs to provide the services. While all of the program areas included in this review agree that improvements can and should be made in both procedures and documentation of the budget review process, it is only the first step in obtaining reasonable assurance that the cost incurred by the contractor and reimbursed by the Department is reasonable and necessary to provide the services. Additional steps include cost reporting by the contractor; fiscal monitoring, audits, and audit resolution by the Department.

With respect to the "questioned costs" of \$297,954, we note that the definition of "questioned costs" used in the report is not limited to unreasonable and unnecessary costs or those costs specifically disallowed by State or Federal guidelines, but also costs "which do not conform to requirements set forth in the conditions of the award/contact." Our examination of the findings at the eight TDH contractors showed that nearly two-thirds of the "questioned costs," \$189,000, was questioned simply because the contractor did not fully comply with a general provision in the contract that all subcontracts be in writing. This condition had already been identified by TDH monitoring and was being corrected by the contractor. The contractor's response to the draft report showed that agreements had been executed with 5 of the providers related to \$47,935 questioned by our auditors. These costs, primarily for physician and other medical services provided to clients, were not questioned by the Fiscal Monitoring Section because such costs are not considered unreasonable or unnecessary (unallowable) just because the current service agreements were not in writing.

Our examination of the total costs "questioned" by the State Auditor indicated that less than \$4,000 (4/100 of 1 percent of the total audited) is unreasonable and unnecessary (unallowable) and will result in the adjustments to the contractors' claims.

Auditor Follow-Up Comment

We do not agree with TDH's assertion that it is acceptable for providers to violate specific terms of the contract. In order to be considered allowable under federal requirements, a cost must conform to both the limitations/exclusions set forth in the cost principles and in the award (contract). TDH's contracts contain a provision which requires that all subcontracts entered into by a provider be in writing and subject to the terms of the contract between TDH and the provider. Our review (as well as TDH's review) found that the provider did not have written contracts with its subcontractors as required by TDH contract provisions and, therefore, we questioned the payments made to the subcontractors.

We originally questioned \$211,251 in payments made to subcontractors without a written contract, but reduced the amount to \$189,000 based on documentation of two contracts submitted by the provider. Other information submitted by the provider was not sufficient to warrant the reduction of the questioned subcontractor payments. Our basis and rationale for these decisions was discussed at several meetings with TDH personnel.

While it is true that the condition had already been identified by TDH monitoring, TDH did not question the costs associated with the payments to the subcontractors, but rather recommended that the contractor maintain and update annual service agreements for the providers. As of January 23, 1996, we had not received documentation that the provider had updated or prepared the required service agreements.

Contracts Include Many of the Provision Necessary to Ensure Contractor Accountability

We agree that TDH contract provisions are adequate to ensure contractor accountability. As noted in the report, the contracts require the contractors to obtain an agency-wide independent financial and compliance audit and provide that contract expenditures comply with federal cost principles for allowability. Specific provisions in our agreements with local government and nonprofit contractors require the application of federal cost principles not only to federal funds, but all State funds the contractors receive from TDH. The required independent financial and compliance audits, including the allowability of cost claimed for reimbursement, had been completed at each of the eight TDH contractors included in this review.

We agree that all contract amendments should be in writing. Our contracts include specific provisions that require amendments be in writing. The actual issue discussed in the audit report is the Department's attempted use of a single contract form for both cost reimbursed and fee-for-service contracts. We have recognized that the approach may lead to confusion and are developing separate contracts for the different type of contracts.

TDH Does Not Have A Formal Process for Determining the Reasonableness of Contractors Budgets

We agree that TDH's process for evaluating proposed budgets for cost reimbursement contracts does not insure that the final and approved budget reflects a fair and reasonable amount for the purchased services. While all of the program areas included in this review agree that improvements can and should be made in both procedures and documentation of the budget review process, it should be recognized that budget review is only the first step to insure cost reimbursed under these contracts is reasonable and necessary to provide the services. Additional steps include cost reporting by the contractor, independent audits, and fiscal monitoring and audit resolution by the Department. Approved budgets generally determine the maximum a

contractor can be paid. The amount the contractor is actually paid is determined primarily by contractor claims and audits of the claims. The independent audits of these contractors resulted in the recovery of \$338,218 that had been reimbursed by TDH in fiscal year 1995.

We generally agree with the reported observations concerning budget review by the HIV Bureau. However, it should be recognized that the budgets for most sole source providers (counseling and testing) are severely restricted with the vast majority of the costs associated with staff salaries, fringe benefits and related travel. Supply costs are strictly limited. Additionally, the budgets for HIV service contractors are reviewed and approved by the local consortia before submission to TDH. The Bureau does agree that improvements are warranted and will develop written guidelines for assessing the budgets that include limits on categories of costs such as travel and supplies.

In those instances where the Bureau approved budgets for amounts greater than originally requested by the contractors, the Bureau also increased the scope of the proposed project, either in area or target population. This is an accepted procedure to fill service gaps and reach unserved or undeserved [sic] populations.

As noted in the report, the Title V program is now on a fee-for-service basis and not subject to the budget review processes of cost reimbursable contracts. We will make the recommended improvements in Title X budget reviews. The conversion of Title X procurement to full and open competition if [sic] fiscal year 1997 will provide further assurance that the proposed budgets are appropriate.

Current Fiscal Oversight Should Be Strengthened To Allow Follow-Up Opportunities in Areas of High-Risk

The statement concerning fiscal monitoring by Grants management, "However, regardless of the nature or extent of the findings identified, additional months are not tested to ensure that similar expenditures were not made and claimed in other months" is incorrect. While it is correct that additional tests are not routinely undertaken, testing has been expanded when justified. Under present policy, monitors are allowed to expand their review if circumstances justify additional work. It is neither efficient nor effective to use the limited monitoring resources to expand tests based on insignificant or isolated findings in the test period. In fiscal year 1995, Grants Management completed risk assessments and target selection programs to better direct the limited resources to potential problem providers. Grants Management's monitoring efforts resulted in the recovery of \$440,408 in unallowable costs from contractors in fiscal year 1993.

Our review of all of the costs "questioned" indicates that less than \$4,000 is actually unallowable. While there may be compliance questions concerning the other costs "questioned," there is sufficient evidence to show the costs were for services that were provided and that the costs were reasonable and necessary.

The examples cited in the report are neither accurate nor representative of the total cost "questioned" by the auditors. Although two-thirds of the questioned cost represents cost incurred by a single contractor simply because subcontracts were not in writing, the condition is not included as an example.

- The \$7,923 amount represents TDH's 39 percent share of a major (\$20,398) communication system, not "questionable telephone repair services." Although contract provisions restrict purchases from related parties and the system was purchased from a related party, our review indicated that the costs from non-related parties were generally to that paid [sic]. TDH's share of questionable service calls that appear unreasonable and unnecessary amount to less than \$500 and will be recovered.
- The \$10,000 in purchases made the last day of the contract were used for clients in the following contract period. Of the total, \$5,000 was spent for the inventory of nutritional supplements that was distributed directly to clients during the following contract period.
- The \$1,780 in expenditures that were over allocated to TDH should have been charged to another State agency and will be recovered. The \$3,464 in payments found to have been made without documentation required by program standards are adequately documented to determine that the costs were reasonable, necessary, and incurred for housing eligible clients.
- The \$5,400 of expenditures described in the report as being made "without obtaining the documentation required by the contract" fully comply with documentation requirements in the contract. Although the documentation does not meet all of the HIV program documentation guidelines, the expenditures are documented to show the costs were incurred for eligible services provided to eligible clients at a reasonable cost.

Auditor Follow-Up Comment

The wording in the report has been subsequently changed to reflect the fact that TDH does not routinely test more than one month of expenditures. We contend that a sample of one month every year (or in some cases, every two years) is not sufficient to adequately identify inappropriate expenditures or "red flags" which might indicate the need for additional testing. In addition, the \$189,000 in questioned costs associated with the subcontractor payments (the "two thirds of the questioned cost . . .") was included as an example in the original draft report, but was removed as a specific example at TDH's request since the issue had already been questioned by TDH monitors.

We do not agree with TDH's assertion that less than \$4,000 of costs we questioned are unallowable. TDH's willingness to overlook contractor expenditures which are clearly unreasonable and unnecessary or in direct violation of the terms of the contract causes us to further question the effectiveness of their contract administration

process. The objective of this audit was to point out questionable practices and uses of public funds, and the examples cited in the report are representative of such.

For example, the \$7,923 (TDH's portion of the total expense) in questionable telephone expenditures were made to a company which employed the husband (ex-husband for part of the period tested) of the provider's executive director. The husband was listed as the salesperson on each of the invoices we reviewed. Although some of the \$7,923 is related to the purchase of equipment and moving the telephone system from one office to another, we still question the reasonableness and prudence of the expenditures.

Our review of invoices indicates a minimum of \$1,200 (TDH's allocation of the total spent on these types of services) was paid for service calls such as:

- \$125 for providing the contractor with a list of phone numbers with dialing instructions
- \$80 for wiring a phone line to the fax machine on May 22, 1995, although this service was previously included on an invoice dated April 13, 1995
- \$75 for reconnecting a power cord at the base of the telephone
- \$80 for turning the telephone ringer back on

As to the \$10,000 in purchases made on the last day of the contract, the other \$5,000 was used to purchase Wal-Mart gift certificates on March 31, 1995, which was the last day of the contract. When we conducted our field review in September 1995, the contractor still had not distributed the gift certificates. The gift certificates were kept in an unlocked drawer, and the contractor had no formal method of tracking the certificates. As a result, it would be difficult to determine if these funds were subsequently used appropriately or not.

During several meetings to discuss these findings, TDH reported that it had approved and encouraged these purchases, but is changing its policies governing such expenditures. However, because the items in question were not used to provide benefits to clients during the contract term, we considered them as questioned costs for the purposes of this report.

The questioned payments made without documentation relate to funds disbursed to clients for assistance with housing costs. During our review of client files, we found that funds were frequently given directly to the clients, and the clients were allowed to write out their own receipts indicating that payment was made to someone else for rent or utilities. Rental contracts were not present in some of the files examined. All of the items mentioned above are violations of program requirements, therefore, we questioned the costs associated with them.

Competitive Processes Used to Select Cost-Reimbursement Contract Providers Do Not Ensure that the Best Contractor Receives the Award

There are a number of valid and proper reasons that HIV prevention, intervention and education contracts are not always awarded to the contractor whose proposal received the highest combined average score. For example, a contractor with an application score lower than others might be selected because the contractor is proposing to serve a broader target population than the other applicants. These decisions are based on criteria in the RFPs and are fully documented. The reasons lower scoring applications are selected are documented in the files and available for review.

The HIV Bureau is also concerned about the wide variations in scores. To address this concern, the Bureau is considering options such as using mock applications to illustrate standards, training, and elimination of high and low scores.

During fiscal year 1996, while competition for the Maternal and Child Health Care (Title V) programs were limited to existing providers, the process was competitive and a number of providers were not refunded.

Family Planning (Title XX) contracts are not automatically awarded to existing contractors. Existing providers have been refunded based upon satisfactory performance as judged by annual written applications, on-site clinical and administrative quality assurance reviews and on-site fiscal reviews by Grants Management. Any new funding, including funds made available from contractors that are not refunded, is competitively awarded. Current plans are to award all Title XX contracts on a competitive basis in fiscal year 1997.

Section 8-B: Controls Over Unit Rate Contracts Do Not Prevent the Inefficient Use of State Funds Provider Expenditures Made Under Unit Rate Contracts Are Not Monitored

We do not agree that "because the unit rates developed for WIC contracts are subjectively determined, TDH still does not have reasonable assurance that providers are reimbursed only for reasonable and necessary costs." The WIC contracts are essentially cost reimbursement contracts with the rates paid during the contract period establishing a limit on the amount of allowable cost that will be reimbursed. WIC contractors are required to account for and report their actual cost. The cost is monitored by WIC fiscal monitoring personnel and audited by independent certified public accounting firms. Actual reimbursements are limited to those cost [sic] found to be reasonable and necessary and under the cap established by the rates already paid.

Rates Do Not Align With Costs to Provide Services

While we agree that the methodologies used to set unit rates should be formalized and documented, we do not believe the current WIC rates have resulted in the payment of unnecessary or unreasonable costs. As previously stated, there are a number of procedures, other than setting rates, which provide reasonable assurances that WIC reimbursements are limited to reasonable and necessary costs.

As stated in the report, Title V and XX rates are based on Medicaid rates. Medicaid generally sets these rates, rates for medical services and supplies, on the basis of reasonable and customary charges by the providers, not the cost of providing the service. As noted in the report, Title XX rates have not been increased along with increases in Medicaid rates. As a result, nearly half of the Title XX rates are less than Medicaid rates for the same service.

With the exception of rates for a few procedures that are not included in Medicaid, the rates paid to Title V providers are the same as Medicaid rates. The rates for the few procedures not directly from Medicaid are based on Medicaid rates augmented to consider the additional services included in the Title V procedure. Although the augmentation was not based on quantitative data, the amounts represent a small fraction of the total program payments. As noted elsewhere, the use of unit rates in the Title V program is expected to reduce program cost by 25 percent without any reduction in client services.

Auditor Follow-Up Comment

As there are no restrictions over how the contractors who are paid a fixed unit rate ultimately use the funds, it is essential that the rate-setting process ensures that there is a reasonable correlation between the costs of service delivery and the rate paid. We agree that basing rates for medical services on prevailing rates is an acceptable method of establishing contractor payments. Our primary concern is that the fees which are not based on Medicaid rates are subjectively determined. As TDH does not audit the actual expenditures of providers reimbursed a unit rate (with the exception of the WIC Program), there are no assurances that contractors are paid a fair and reasonable rate for the services provided.

Competition for Awarding Some Programs' Contracts Is Limited, And the Results of Proposal Evaluations Are Not Always Adequately Documented

We agree that competition in awarding WIC contracts is limited and that the results of proposal evaluations can be better documented. The criteria used in the evaluations and the results of the evaluations will be better documented in the future. With respect to competitive awards, it should be recognized that WIC has had difficulty in finding enough contractors to provide services statewide. The Department's investment in equipment and training in the current contractors [sic] along with the federal requirement that the contractors provide health service further limits the use of

competitive awards. However, as noted in the report, as new funds become available, new contracts are awarded on a competitive basis.

Title XX provider applications are not automatically renewed, irrespective of content. The providers are evaluated on the basis of their applications, on-site clinical and administrative quality assurance reviews, and on-site fiscal monitoring and independent audits. Poorly performing providers are not refunded and their allocations are competitively awarded. Although the contracts have not been competitively awarded since the program was transferred from DHS in 1993, we plan to award all Title XX contracts on full and open competitive basis [sic] in fiscal year 1997 and beyond.

TDH COMMENTS ON OVERALL RECOMMENDATIONS

- **Develop and implement contract provisions designed to hold all contractors accountable for the appropriate and effective use of State funds.**

Cost reimbursable contracts awarded by TDH do contain explicit requirements that all costs claimed for reimbursement by the contractors be allowable in accordance with applicable federal cost principles. In addition to fiscal monitoring by TDH, all such contracts are audited in accordance with federal requirements to determine the contractors' compliance with this and other requirements. To the extent such audits disclose unallowable costs claimed by the contractors for reimbursement, the amounts are recovered.

Unit rate or fee-for-service contracts require considerable administrative effort in establishing fair and reasonable payments rates for contractors. This is particularly true in those instances where the rates are based on cost reports or factors other than already accepted Medicaid rates. Once appropriate rates are established, we do not believe that unit rate contracts should routinely contain provisions that limit the contractor's reimbursement to the lower of the rate paid or the contractor's reasonable, necessary, and allowable costs to provide the services. Similarly, we do not believe that a cost settlement based on an audit at the end of the contract term would be appropriate. Such an arrangement would essentially be a cost reimbursable contract with the provisional payments (rates) paid during the term of the contract representing an additional ceiling on reimbursements. Such an arrangement would negate the administrative simplicity of unit rate contracts and prove quite costly, both to the State and the contractor, to administer. The WIC program does use this method, but primarily as a means to limit reimbursements to available statewide funding.

TDH's fee-for-service contracts are, for the most part, for professional medical services. Prevailing rates or reasonable charges, not cost, are an accepted method of paying for these services throughout government.

Auditor Follow-Up Comment

As mentioned in our recommendations, we agree that provisions which limit compensation and require cost settlements at the end of the year may increase administrative requirements and, potentially, the cost of contract administration. However, this is just one of the options available to enhance controls over contractors' use of public funds. Ultimately, it will be up to agency management as well as the appropriate oversight bodies to determine the trade-offs between the costs of better controls and the costs of inappropriate expenditures.

- **Develop methods of establishing contractor payments that reflect only the necessary and reasonable costs of providing services.**

We agree that there should be a standard method to identify cost elements used in determining cost based reimbursement unit rates and that such a method would help ensure various agencies pay the same contractor similar rates for similar services.

As noted previously, we do not believe that unit rate contracts should routinely include end-of-term cost settlements. Such a provision would require the contractor to specifically account for the service cost and the agency to audit and settle the contract costs. The absence of the administrative effort and cost to do these tasks is the main advantage unit cost contracts have over the cost reimbursable contracts.

We agree that cost reports used in developing cost based unit rates should be accurate and, to the extent feasible, sanctions should be developed and implemented for false reporting.

We agree that the review of proposed budgets for cost reimbursable contracts should be strengthened. While some TDH programs follow well developed criteria, the procedures used by others are not as fully developed and documented. (The Department's Contract Leverage Team has addressed this area and improvements will be forthcoming.)

- **Establish centralized oversight responsibility for contract management of service providers, in particular, fiscal monitoring.**

We agree that a single audit of a provider's total state funding is appropriate. All contractors receiving \$25,000 or more from TDH do undergo a single audit by an independent certified public accounting firm to determine, in part, if the contractor has complied with federal cost principles with respect to all federal funds and those State funds received from TDH. Such an audit of federal funds received from the federal government is required by federal laws and regulations. We require the same audit of State funds received from TDH by specific provision in each contract. Single audits had been performed on all eight of the TDH contractors included in this review. We have already completed quality assessments of two of the audits and we will soon be taking actions to address any deficiencies found in these audits.

We also agree that a centralized contractor data base would be helpful in several ways. Such a data base of health and human services contractors is one of the expected outcomes of the work now underway in the task force headed by the Health and Human Services Commission.

- **Use competitive procurement procedures whenever possible.**

We agree that competitive procurement should be used whenever *practical*. Although there are instances where competitive procurements are possible, such procurement may not be practical. For example, in the WIC program it is difficult to obtain any contractors in certain areas of the State. Not only does the Department have a considerable investment of equipment and training in the current contractors, federal regulations limit the selection of contractors to health providers. We do, however, support the concept of competitive procurement and plan to expand such procurement to the extent practical.

TDH COMMENTS ON SPECIFIC RECOMMENDATIONS TO TDH

- We agree. Grants Management does expand testing of expenditures when significant amounts of questioned costs or particular categories of questioned costs are found in its one-month sample.
- We agree. The report does not indicate any concern with the experience levels of unit-rate contract negotiators. To the contrary, the report indicates concern should the current WIC evaluators leave the agency.
- We agree. While the selection of WIC providers is currently made against predetermined criteria, the criteria and the process will be better documented.
- We agree. Scoring sheets for all programs that use a competitive award process that do not currently have such tools will be developed. The evaluation criteria will define acceptable and unacceptable levels of performance for each criterion and be included in the RFPs.
- We agree. Guidelines for reviewing the reasonableness of proposed budgets for cost-reimbursement type contracts will be developed. The guidelines will include criteria for evaluating administrative and other fixed expenses relative to service costs.
- We agree. We are currently developing different types of contracts to include only those provisions that apply to that particular type of contract.
- We agree. The methodology and assumptions for developing rates for unit rate contracts will be formalized and documented.

Texas Department of
Mental Health and Mental Retardation

Don A. Gilbert, M.B.A.
Commissioner



January 25, 1996

Central Office
P.O. Box 12668
Austin, TX
78711-2668
(512) 454-3761

Cindy Reed, Project Manager
Texas State Auditor's Office
206 East 9th Street, Suite 1900
Austin, Texas 78701

Dear Cindy:

Attached are the responses to the draft findings for the Contract Administration at Health and Human Services Agencies (CM-3)-Audit Report. If you have any questions, please contact Tom Martinec, 323-3147.

Sincerely,

A handwritten signature in black ink, appearing to read "Don Gilbert".

Don Gilbert
Commissioner

Responses to SAO Draft Audit Report on Contracts Management

Recommendation

Develop and implement contract provisions designed to hold all contractors accountable for the appropriate and effective use of state funds.

Response:

All contractors should be held accountable for services purchased by the state, but the solutions offered under this recommendation and others are the most costly to administer for large state-wide programs. The Department is currently working along with other health and human service agencies in developing recommendations and processes addressing contract management from a system perspective. Important areas being addressed by these agencies including the strengthening of contract language along with various legal issues. The HHSC agencies have developed a recommendation that the agencies immediately use the full range of sanctions available to them, and identify these sanctions in the contract.

Additionally, community centers are required to follow federal cost principles (e.g., OMB Circular A-87 regarding allowable and unallowable costs), and are required to have an annual Single Audit performed by independent CPAs. These CPAs are responsible for assessing each community centers' internal controls and compliance with applicable laws and regulations, including cost principles. In addition, efforts are being made to improving the quality and scope of these independent auditor reviews.

Recommendation

Develop methods of establishing contractor payments that reflect only the necessary and reasonable cost of providing services.

Response:

The Department agrees that a standardized methodology should be used to identify elements of cost to be used in determining the contracted rate, but private providers cannot access the hotel and travel discounts available to the State of Texas.

Total costs do not vary that dramatically across the state for all programs, so varying rates on a geographic basis or through year-end settlements would not be cost effective for all programs.

We agree that sanctions should be strengthened to assure that cost reports are accurate and to deter reporting of false data on cost reports. We also agree that cost report training should be mandatory for all providers.

Recommendation

Establish centralized oversight responsibility for contract management of service providers, in particular, fiscal monitoring.

Response:

As stated previously, the Department, along with other health and human service agencies, is working towards making recommendations and developing processes that would address contract management from a HHSC system perspective. An important part of this initiative is the coordination of monitoring activities to eliminate duplication of effort, while allowing each agency the authority to monitor/sanction its own contracts. Potential recommendations in this area include coordinated Single Audits of contractors and development of best practices models among agencies.

Recommendation

Enhance its procedures for monitoring the financial aspects of its contracts. The Department should ensure that these procedures include a contractor risk assessment procedure to select contractors for review, periodic on-site reviews of the financial records of high-risk contractors, and follow-up procedures to ensure the financial issues identified at contractors have been resolved.

Response:

We agree. The Department is currently working on strengthening the fiscal monitoring of the the community centers. The Department is also involved with the other health and human service agencies in developing a formal risk assessment process to be used in establishing fiscal and programmatic contract monitoring plans. As stated previously, the community centers' independent auditors are responsible for examining the centers' internal controls and compliance with cost principles. The Department is currently working towards improving the quality of these independent auditors' work so that it can used in fiscal monitoring of contractors.

Recommendation

Review and amend each of its contracts to ensure that the contracts contain clear provisions which set forth the definitions of allowable and unallowable costs under the contract. Additionally, the Department should review and amend its contracts to ensure that the contracts contain adequate provisions describing the process by which unallowable expenditure amounts will be refunded to the Department.

Response:

We agree. The refund of unallowed expenditures is applicable to community centers. The community centers' independent auditors are responsible for ensuring that the centers comply with federal and state cost principles, including the allowability of certain costs. The Department has taken the position that it may recoup funds that have been used inappropriately (services to persons not within the priority population). Controls are currently in place to ensure the recoupment of funds. With regard to funds that may be used inefficiently, the Department's most toward limiting indirect costs is a positive step. As costs are identified, the Department can judge community center efficiency more accurately.

Additionally, the Department is working along with other health and human service agencies in implementing contract language that would more easily allow the recoupment of unallowable costs. The HHSC agencies have developed a recommendation that the agencies immediately use the full range of sanctions available to them, including recoupment of funds, and identify these sanctions in the contract.

Recommendation

Take action to promptly comply with the legislative requirement to examine its rate-setting methodologies for the ICF-MR contracts and the home and community-based services contracts. Efforts in this area should also include work to address and correct the known weaknesses in the current rate-setting methodologies.

Response:

TDMHMR is presently working on reviewing the reimbursement methodology for both the ICF-MR and the Home and Community-Based Services. Deloitte and Touche have been engaged by the Department to develop new reimbursement methodologies in FY96. Issues concerning the current rate-setting methodologies have already been addressed.

Recommendation

Take action to promptly address and correct each of the weaknesses in the Department's contracting process identified by Department internal auditors. As part of this effort, the Department should ensure that contract managers receive formal training in contract negotiation, financial analysis, and contract management. In addition, the funding allocation process should be refined to better reflect the actual cost of providing services, as well as the individual needs of the particular area which the contractor will serve.

Response:

The Department agrees that financial training and standardized evaluation criteria would benefit all parties involved in the contracting process. The Department is considering offering formal training to contract managers, or seeking this training outside of the Department. Additionally, contract managers will soon receive financial ratio information about the various community center, as well as instruction on the use of this information as a contract management tool.

Objective, Scope, and Methodology

Objective

The primary objective of this project was to identify instances of fraud, waste, or abuse of taxpayer funds and to determine specific systemic weaknesses at the Department of Human Services, Department of Protective and Regulatory Services, Department of Health, and Department of Mental Health and Mental Retardation which would allow such instances to occur. To accomplish this, we focused on determining the following:

- Do service providers spend state funds appropriately and efficiently?
- Do procedures used to select contractors ensure that the best contractor is fairly and objectively selected?
- Do the rate-setting methodologies used to establish reimbursement rates for unit-rate contracts ensure that the State pays a fair and reasonable price for the services?
- Do procedures used to establish contract budgets for cost-reimbursement contracts ensure that the State pays a fair and reasonable price for the services?

Scope

The scope of this audit included purchased client service contracts for the four agencies specified above. The contract period varied between agencies and programs, but generally we reviewed records for the contractors' most recently completed fiscal year (in most cases fiscal year 1994).

We reviewed the financial records of 20 service providers who provide client services for the four agencies specified above. The majority of the service providers were selected randomly from a list of 100 service providers who received the most funding in fiscal year 1994 from the four agencies included in our review. We also focused our selection on contractors who received funding from more than one state agency. Our work included review of 55 contracts totaling over \$79 million. The contracts covered 35 different programs from the four funding agencies.

Providers were given a copy of all potential findings and questioned costs and were asked to submit additional information which might clear the findings. The questioned costs contained in this report have been reduced accordingly for any information subsequently submitted by the service provider.

Our work at the four funding agencies included the following areas:

- contract provisions
- contract monitoring methodologies, policies, and practices
- contractor selection policies and practices

- rate-setting methodology, policies, and practices
- processes used to establish contract budgets

Methodology

The methodology used on this audit consisted of collecting information, performing audit tests and procedures, analyzing the information, and evaluating the information against pre-established criteria.

Information collected to accomplish our objectives included the following:

- Interviews with management and staff of the Department of Human Services, Department of Protective and Regulatory Services, Department of Health, and Department of Mental Health and Mental Retardation
- Interviews with executive directors and accounting staff from the 20 service providers
- Interviews with staff from the Health and Human Services Commission
- Documentary evidence such as:
 - Policies and procedures related to contract administration and rate-setting practices at the four funding agencies
 - Applicable federal and state statutes and guidelines
 - Contract files/contractor selection files from the funding agencies
 - Accounting policies and procedures used by the service providers
 - Service providers' board minutes

Procedures and tests conducted:

- Review of sufficiency of contract provisions and tests of provider compliance with contractual terms
- Tests of service providers' revenue transactions to determine if revenue was properly accounted for
- Tests of service providers' expenditures to determine if expenses were reasonable and necessary to the program objectives and specifically allowed by state or federal guidelines where applicable
- Tests of service provider billings to the funding agencies to determine if services billed for were rendered and if services were only billed to one funding source
- Tests of the contractor selection processes at the funding agencies to determine if the best contractor was objectively selected
- Tests of cost reports prepared by service providers to determine accuracy of information used in the rate-setting process
- Review of the process used to evaluate contract budgets proposed by service provider

Criteria used:

- Best business practices related to contract administration
- Federal guidelines and cost principles: OMB Circulars A-87, A-122, A-110, and A-102 and Federal Acquisition Regulations 48 CFR Ch. 1
- Contract management model developed by the State Auditor's Office

- Department policies and procedures
- Cost report methodology for applicable programs
- Standard audit criteria

Fieldwork was conducted from August 8, 1995 through December 15, 1995. The audit was conducted in accordance with applicable professional standards, including:

- Generally Accepted Auditing Standards
- Generally Accepted Government Auditing Standards

There were no significant instances of noncompliance with these standards.

The audit work was performed by the following members of the State Auditor's staff:

- Cynthia L. Reed, CPA (Project Manager)
- Julie L. Cleveland
- Susan P. Driver, CPA
- Leslie Bavousett, CPA
- Kimberly Bradley
- Eric B. Corzine
- Janice Engler
- Francine Gutierrez
- J. Frank Guerrero
- Kevin Hannigan
- Mattye Keeling
- Nancy L. McBride
- Kelley Martin
- Angelica Morales-Carrillo
- Marilyn Polston
- Monday Rufus, CPA
- Ryan G. Simpson
- Mary Beth Whitley
- Kay Wright Kotowski, CPA (Audit Manager)
- Craig D. Kinton, CPA (Audit Director)

Also, personnel from the Internal Audit Divisions of the Department of Human Services, Department of Protective and Regulatory Services, Department of Health, and Department of Mental Health and Mental Retardation assisted us in our work.

Key Points from Selected SAO Reports on Contract Monitoring

***An Audit Report on Contract Administration at the
Texas Youth Commission
September 1995
SAO Report No. 96-005***

Key Facts and Findings

- Contractors for the Texas Youth Commission are not adequately monitored to ensure quality services are provided. None of the 46 contract files randomly selected for review had documentation that the service provider had been monitored on a quarterly basis as required by Commission policy. Four of these contracts were renewed with contractors despite current performance problems.
- The Commission has developed outcome and output measures to gauge the performance of residential care contractors. However, our review found that the Commission's monitors rely on performance measure reports primarily only when preparing annual provider evaluations and not for routine, ongoing assessment and monitoring of provider performance. As a result, available performance data is not used to maximize and focus limited monitoring resources.
- The Commission's current level of fiscal oversight is not sufficient to ensure that the agency receives the best value for its contracting dollar. The Commission does not systematically set rates for contracts and does not adequately monitor contractor financial controls or the use of start-up funds. Our review of Commission service providers found that the rates paid to contractors sometimes exceeded the costs to provide services as evidenced by an accumulation of fund balances. For the three providers we reviewed, fund balances totaled over \$1.6 million. There are no current state statutes which require the Commission to limit contractors' expenses to certain categories of cost. However, this should not preclude the Commission from including reasonable limitations in its contracts.
- The majority of existing contracts at the Commission were not awarded using a competitive bid process. Only 11 of the 46 contracts we reviewed were awarded using a Request for Proposal. While state statute requires the Commission to select contractors based on qualifications and demonstrated competence of the provider, the majority of contracts we reviewed were awarded based only on recommendations by regional directors and contract monitors.

A Review of Contract Monitoring of Purchased Services
October 1994
SAO Report 95-007

Key Points of Report

- Agency oversight of contractor performance does not provide sufficient information to determine if taxpayers' funds are allocated to contractors who consistently provide the best services. During fiscal year 1993, the health and human services programs included in our review paid over \$2.5 billion to contractors who are responsible for providing services to protect and enhance the health, well-being, and productivity of Texas citizens.
- Most contractors are held accountable by judging whether their activities follow the procedures laid out in regulations, rather than the outcomes or results they produce. None of the 225 contracts we reviewed contained specific outcome measures requiring the contractor to perform at a certain level of success.
- No standardized contract monitoring process exists within the State or even within individual agencies. Most agencies have not established standardized criteria to evaluate contractor performance. As a result, it was difficult to determine if the performance of the contractor had been adequately monitored or not.

***A Management Control Audit of the Texas Commission
for the Blind
October 1995
SAO Report No. 96-008***

Key Facts and Findings

- The Texas Commission for the Blind furnishes blind and visually impaired Texans with information needed to make informed decisions and access to services which increase their opportunities for employment or self-sufficiency. With 556.11 full-time equivalent employees, the Commission served 23,494 consumers through various programs during fiscal year 1994. Total appropriations for the year were \$39,060,851.
- Two agency oversight functions, the Board of Directors and internal audit, were not providing sufficient guidance in Commission policy and providing necessary feedback on its programs and operations.
- Although the Commission recognized the need to improve its automated information systems in its current Information Resources Strategic Plan, the Information Resources division still lacks sufficient experienced staff, management controls, and technology to effectively support the agency's programs and administrative needs.
- The purchasing and contract administration processes are not fully developed. Without established and documented benchmarks and performance standards, the agency does not have adequate means of evaluating its purchasing employees' and contractors' performance.
- Agency staff do not verify the approximately \$14 million in sales from the Business Enterprise Program facilities and unmanned vending operations. As a result, there is a continued risk that BEP managers and vending machine companies will underreport the income from their predominantly cash businesses.

**An Audit Report on Management Controls at the
Texas Rehabilitation Commission**

October 1995

SAO Report No. 96-012

Overall Conclusion

The Commission generally has effective management controls, but it does not have a fully developed contract management system to ensure quality provider services at a reasonable cost.

Key Facts and Findings

- The Commission's records show that it spent approximately \$121 million on services for clients during fiscal year 1994, but it has developed formal contracts for only \$2 million. While developing contracts with providers for all client services may not be feasible, the Commission should use contracts when providers meet certain criteria, such as high dollar volume.
- The Commission does not have a formalized cost-based methodology to set rates for client services or an adequate system for monitoring providers' financial controls. This increases the risk that the Commission may be paying too much for some client services.
- The Commission has undertaken a reengineering effort which is expected to increase the agency's efficiency in delivering services to Texans with disabilities. For example, to provide faster delivery of client equipment, the Commission is moving from using a centralized warehouse toward buying from large volume local providers. However, the Commission encountered problems in the initial organization and management of the reengineering project. As a result, it changed its original specifications, which delayed plans for the October 1, 1995, system implementation.
- The Disability Determination Services Division has taken steps to reduce the number of case files waiting for examination and to shorten case processing time. As a result, management reports that the number of cases waiting assignment to an examiner dropped from an average of 9,490 in March 1995 to an average of 1,000. Management also reports that its mean processing time decreased from 90.5 days in April 1995 to 71.3 days in August 1995.

***A Review of Management Controls at the Interagency Council
on Early Childhood Intervention***

November 1995

SAO Report No. 96-020

Overall Conclusion

The Interagency Council on Early Childhood Intervention (Council) has generally established a strong system of management controls. However, some controls need strengthening. With minor exceptions, the Council is in compliance with applicable laws and regulations.

Key Facts and Findings

- The language in provider contracts relating to sanctions for noncompliance or poor performance is vague. This has the potential to hinder the timely enforcement of requirements under the contract.
- Controls over internal audit should be improved. The Council has no internal audit charter. The internal audit contract did not restrict subcontracting, leaving the Council with no control over who would perform the work.
- The Council should strengthen provisions in the contract with the Department of Human Services. The contract's performance standards are not comprehensive, and there are no sanctions for poor performance. This hinders the Council's ability to address poor performance.
- The Council operates with a budget of \$42.7 million and a staff of 64. About one half of its funding is from the Federal Government. Over 90 percent of the Council's funds are disbursed to service providers.

***A Report on Management Controls at the Texas Department
on Aging
December 1995
SAO Report No. 96-030***

Overall Conclusion

The Department does not have traditional, formal contracts in place with those who actually provide program services and has not adequately monitored the Area Agencies on Aging (AAAs) to ensure that high-quality services have been delivered to the appropriate people at a fair price. Developing contracts, implementing efficient and risk-based monitoring practices, and fully analyzing available performance data would better enable the Department to ensure the safe, efficient delivery of quality services.

Key Facts and Findings

- The Department has not developed traditional, formal contracts with the 28 AAAs. These AAAs are responsible for administering the \$52 million program for the Department. As a result, the Department has little recourse should performance problems occur.
- The Department has not adequately used available information to measure and manage AAA performance. For example, the Department has not analyzed the cash rates it approves to determine if rates are reasonable. In reviewing reimbursement rates for meals served in a group setting, we found that the Department reimbursement rates ranged from no reimbursement to \$4.00 per meal.
- The Department has not adequately monitored some AAAs, and, in turn, some AAAs have not adequately monitored their providers. For example, we found that as of April 1995, one AAA had not conducted a program monitoring visit since March 1994. AAA providers offer nutrition, transportation, and in-home services to elderly individuals. Therefore, it is important that the AAAs monitor providers to ensure that vehicles are properly maintained, drivers are trained in the safe use of wheelchair lifts and other special equipment, that the possibility of food-borne illness is minimized, and that in-home workers are qualified to perform their duties.
- The rates developed by the Department are not aligned with the actual cash cost to provide services. Volunteer and in-kind contributions are given a value and included in the rates paid to AAAs, clouding the true cash cost of providing services. Changes to the current rate-setting process could improve accountability by making rates comparable among AAAs and with the contracted rates providers have with other agencies.

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