



John Keel, CPA
State Auditor

An Audit Report on The Department of Information Resources' Administration of the TexasOnline Contract

November 1, 2005

Members of the Legislative Audit Committee:

In September 2005, the Department of Information Resources (Department) significantly strengthened the provisions of its Framework Agreement (hereafter referred to as the contract) with the contractor that is developing and operating TexasOnline, the e-government Web portal for the State of Texas. However, the Department should improve its contract monitoring, and in future contracts it should establish additional contract provisions.

Since its inception in 2000, TexasOnline's development and operation have been financed through a unique arrangement. The contractor agreed to pay the cost of system development in exchange for retaining between 80 to 100 percent of TexasOnline gross revenues that are generated through the fees charged for services offered through TexasOnline. The State receives the remaining gross revenues (see Table 3 in Part 3 of the attachment to this letter for additional details). When the contractor recovers its costs and breaks even, the State will begin receiving 50 percent of TexasOnline net revenues and assume ownership of TexasOnline assets.¹

Because of this arrangement, it is important for the Department to monitor the costs that are charged to the TexasOnline project so that the State can maximize its share of revenue from TexasOnline. The TexasOnline contractor complied with the majority of the contract requirements we audited. We identified nearly \$1.3 million in expenditures that require the Department's further review (approximately 1.6 percent of the \$83.1 million in total TexasOnline expenditures). Because of the financing arrangement, the Department should (1) place greater emphasis on its monitoring of the contract, including monitoring of the components of indirect costs, and (2) establish specific contract provisions in future contracts to better protect the State's financial interests.

The remainder of this report outlines our conclusions regarding the specific contract monitoring, contract establishment, financial reporting, and revenue audit objectives we pursued.

TexasOnline Background Information

In August 2000, the State launched TexasOnline, its e-government Web portal for state and local government business. TexasOnline offers more than 300 online services, such as driver's license renewals, sales tax filing and payments, and traffic and parking fine payments.

TexasOnline Costs and Revenues

As of February 2005:

- The cost of TexasOnline development and operations totaled \$83.1 million.
- The gross revenue generated through TexasOnline applications totaled \$70.4 million.

Additional detail regarding TexasOnline costs and revenue is provided in Part 3 of the attachment to this letter.

¹ In addition to receiving 50 percent of TexasOnline *net* revenues, the State will continue to receive the share of *gross* revenues to which it is entitled.

Does the Department adequately monitor to ensure compliance with the terms of the contract and contract renewal agreements?

The Department should strengthen its monitoring of the costs charged to the development and operation of TexasOnline. Auditors identified \$1.3 million in expenditures charged to TexasOnline that require the Department's further review. While those expenditures do not represent a significant percentage of the \$83.1 million in total costs charged to the project through February 2005, they demonstrate that monitoring should be improved. Audit testing also identified discrepancies in the TexasOnline asset inventory that indicate a need for the Department to better monitor these assets. (Part 1 of the attachment to this letter contains additional details regarding the expenditures that require the Department's further review and inventory discrepancies identified during this audit.) In addition, neither the Department nor the contractor has documentation justifying a 2004 increase in the fee the contractor charges to use its payment engine, which is the mechanism through which TexasOnline collects payments and fees. This fee increase resulted in \$437,000 in additional charges to TexasOnline.

The TexasOnline contractor also did not always comply with a contract requirement to obtain the Department's written approval of the transfer portion of each software license agreement prior to executing each licensing agreement. Without reviewing and approving the transfer portion of each agreement, the Department cannot ensure that software licenses can eventually become the property of the State free of charge. We identified software licenses between the TexasOnline contractor and software vendors that did not include a transferability clause. Although there is assignability language in the purchase orders, there is no evidence that all software vendors have agreed with this language.

Although the Department obtains annual audits of TexasOnline's financial statements, those audits should be considered as only one component of a more extensive and ongoing monitoring mechanism that should be in place to protect the State's financial interests. In response to a March 2002 State Auditor's Office audit (see *An Audit of the Department of Information Resources' TexasOnline Contract*, SAO Report No. 02-031), the Department developed its *Contract Management Standards Manual*; however, that manual was not disseminated to all Department staff who are responsible for monitoring, and the Department is not conducting the detailed quarterly audits required by this manual. The Department had developed a project plan for monitoring, but Department management stated that not all tasks were completed due to financial and time constraints.

Recommendations:

The Department should:

- Follow up on expenditures identified during this audit and deduct those that violate the contract from total TexasOnline costs.
- Perform quarterly audits of the TexasOnline contractor as required by its *Contract Management Standards Manual*. These audits should test a representative sample of TexasOnline transactions for allowability and include periodic inventories of TexasOnline assets.
- Formalize and document its TexasOnline contract monitoring program; disseminate that information to all staff involved in contract monitoring; and ensure that those staff receive training necessary to carry out their new monitoring responsibilities.

- Retain supporting documentation for all key management decisions, including the approval of fee increases.
- Work with software vendors and the contractor to obtain explicit vendor approval of the transfer of software ownership from the contractor to the State free of charge.

Does the Department pursue opportunities to strengthen the contract during contract negotiations?

When the Department renewed the TexasOnline contract for the first time in February 2002, it added certain provisions to strengthen contractor accountability. For example, it added provisions giving the Department more access to the contractor's financial data, tightened budget submission and approval requirements, and standardized the financial reports that the contractor is required to provide. Although those provisions strengthened the contract to some degree, significant weaknesses remained in the contract, and those weaknesses posed significant risks to the State's financial interests.

In June 2005, the State Auditor's Office provided suggestions based on audit fieldwork for strengthening contract provisions pursuant to a rider in the General Appropriations Act. In September 2005, the Department added several new contract provisions that addressed a variety of contract weaknesses, including some of the provisions suggested by the State Auditor's Office and the Legislative Budget Board. Those provisions are discussed in more detail in Part 2 of the attachment to this letter. Selected provisions that the Department added were provisions to:

- Specify that the contractor will break even and that the State will assume ownership of TexasOnline assets no later than December 31, 2006.
- Ensure that the State could have access to the TexasOnline contractor's payment engine if the contract is terminated. Without this payment engine, TexasOnline payments cannot be processed electronically.
- Tighten the process for the Department's approval of certain items, including the TexasOnline budget, contractor rate increases, and the contractor's selection of subcontractors.
- Strengthen controls over contractor expenditures by (1) specifying that the contractor charge a 7 percent mark-up charge on certain third-party invoices, rather than the previously allowed 6–9 percent range of mark-up charges; (2) adding specificity regarding allowable and unallowable costs that could be charged to TexasOnline; and (3) requiring the contractor to maintain supporting documentation for its expenditures.
- Require the contractor to insert language in its contracts with local governments that require the local governments to pay any unrecovered costs if they discontinue participation in TexasOnline. When certain local governments discontinued their participation in TexasOnline, the State was left with \$495,000 in unrecovered costs.

While the contract provisions described above significantly improved protection of the State's financial interests, this audit identified issues that highlight the need for three additional contract improvements that the Department should implement in future contracts:

- The contract does not define the components of overhead and general and administrative costs that can be charged to TexasOnline. Defining the specific components of overhead and general and administrative costs is important because it would enable the Department to ensure that only allowable costs are charged to

TexasOnline. In addition, because overhead and general and administrative costs have been charged to TexasOnline in three ways (directly, through mark-up charges on certain third-party transactions, and through surcharges that are included within salary costs), defining the components of overhead and general and administrative costs would enable the Department to ensure that the same costs are not charged to TexasOnline multiple times. Based on rates in effect during fiscal years 2000 and 2001, auditors estimated that approximately \$26.1 million in overhead and general and administrative costs had been charged to TexasOnline through February 2005. However, without clear definitions of overhead and general and administrative costs, this amount cannot be determined with certainty and auditors cannot determine what, if any, portion of these costs may have been duplicated.

- The contract does not define all of the components of the salary rates that can be charged to TexasOnline. As with overhead and general and administrative costs, defining all of the components of salary rates would enable the Department to ensure that only allowable costs are charged to TexasOnline. Auditors tested TexasOnline salary charges for six quarters in fiscal years 2003 and 2004 and estimated the costs of the four components that should constitute those salary charges: payroll, benefits, overhead, and general and administrative costs. However, the sum of those four costs was approximately \$500,000 less than the total associated salaries charged to TexasOnline for that time period. This indicates that an additional, unidentified (and potentially unallowable) cost component may be included within salary rates. The absence of a clear definition of the components of salary rates prevents this from being determined with certainty.
- Other than contract termination, the contract lacks penalties for contractor noncompliance with contract provisions that are not related to system performance. Currently, contract termination is the only penalty available to address instances in which the contractor does not comply with the contract provisions that are not related to system performance. Because contract termination could pose risks to the State in terms of the continued operation of TexasOnline, establishing additional types of penalties for contractor noncompliance would be more beneficial to the State.

Recommendations:

The Department should:

- Ask the TexasOnline contractor to provide it with the components of salary, overhead, and general and administrative costs that are charged to TexasOnline to assist in its monitoring of costs.
- Establish and enforce procedures to address instances in which the TexasOnline contractor does not comply with contract provisions that are not related to system performance.
- For future contracts:
 - Define the components of overhead and general and administrative costs that can be charged to the contract.
 - Define all of the components of salary costs that can be charged to the contract.
 - Consider all aspects of contract formation and management—including adequate provisions to hold contractors accountable and the most appropriate contractor payment methodology (for example, fixed price or cost-reimbursement) and related monitoring mechanism—to ensure that the contract protects the State's financial interests.

- Include graduated sanctions, including financial penalties, that are sufficient to hold the contractor accountable for failing to meet contract provisions (in addition to sanctions for noncompliance related to system performance).

Does the contractor provide accurate and useful financial reports?

We did not identify any material inaccuracies when we tested the schedules that support the monthly balance sheets and statements of operations the TexasOnline contractor submits to the Department. In addition, the contractor's monthly financial reports include information that is useful for high-level monitoring. The Department also requires the contractor to prepare its monthly financial statements using a standard format and it requires the contractor to prepare its financial reports in accordance with generally accepted accounting principles promulgated by the Governmental Accounting Standards Board. Both of these requirements enhance the usefulness of these reports.

The Department reviews the TexasOnline contractor's monthly financial reports for mathematical accuracy and unusual variances. As discussed in more detail above, however, the Department could improve its monitoring by testing a representative sample of TexasOnline transactions for allowability.

Is revenue due to the State monitored, verified, and deposited in the State Treasury?

The State is receiving the amount of revenue it should be receiving from TexasOnline. In fiscal years 2002 through 2004, the amount that the TexasOnline contractor deposited in the State Treasury for the State's 10 percent share of TexasOnline gross revenues was not materially different from (1) the amount of the State's share recalculated from information in the contractor's general ledger or (2) the amount reported in the TexasOnline financial statements. The State received \$6.2 million in revenues from TexasOnline between September 2001 and February 2005.

TexasOnline generates revenue from (1) transaction-based convenience fees collected from the end user or government entity and (2) service fees including occupation license subscription fees, hosting fees, and development service fees.

Part 4 of the attachment to this letter contains information regarding additional issues for the Department's consideration.

**Summary of
Objective, Scope, and Methodology**

The overall audit objective was to determine whether the Department and the TexasOnline Authority protect the State's financial interests.

The audit scope covered all costs associated with and revenues earned by TexasOnline from inception in May 2000 through February 2005.

This audit was conducted in compliance with generally accepted government auditing standards, which require independence in both fact and appearance.

An immediate family member of the State Auditor is registered with the Texas Ethics Commission as a government relations employee of a firm that conducts lobbying efforts on behalf of a contractor included in the scope of this audit. This condition could be seen as potentially affecting our independence in reporting results related to this contractor. This condition did not affect our audit conclusions and is discussed further in Part 5 of the attachment to this letter.

The Department agrees with our recommendations, and its responses are included in Part 6 of the attachment to this letter. We appreciate the Department's cooperation during this audit. If you have any questions, please contact Sandra Vice, Assistant State Auditor, or me at (512) 936-9500.

Sincerely,

Susan Riley, CPA
Assistant State Auditor

Attachment

cc: Mr. Larry Olson, Chief Technology Officer of the State of Texas and Executive Director
of the Department of Information Resources
Members of the Department of Information Resources Governing Board



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Attachment

Part 1

Audit Testing Identified Expenditures that Require Further Review and Discrepancies in Asset Inventories, but These Were Not Significant in Proportion to Total Costs and Assets

Table 1 lists the expenditures identified during this audit that require further review by the Department of Information Resources (Department), which totaled \$1,299,200. The Department should examine these expenditures more closely and, as applicable, require the TexasOnline contractor to provide supporting documentation for these expenditures. While those expenditures represented approximately 1.6 percent of the \$83.1 million in total costs charged to the project through February 2005, they demonstrate that the Department's monitoring of expenditures should be improved. It should also be noted that auditors identified instances in which the contractor undercharged TexasOnline by \$31,700 for certain expenditures, primarily in the area of payroll.

Table 1

Expenditures Requiring Further Review Identified During This Audit		
Expenditure Type	Reason Expenditure Should be Reviewed	Amount
Payroll charges	These 2000-2001 payroll charges were associated with contractor staff who were not listed in the contract. The February 2002 renewal agreement reduced billing rates retroactive to the beginning of the contract in May 2000. Because it was allowed to negotiate billing rates retroactively, the contractor should have listed in the contract renewal agreement all staff who were charging time for the time period prior to that renewal agreement. Auditors did not find evidence that these individuals had been approved by the Department as required in the contract.	\$819,400
Payroll charges	These payroll charges were for overtime, which is prohibited by the contract. One reason that this occurred is because the contractor's time accounting system allows for bypassing controls designed to prevent the entry of overtime. For example, the system allows double entry of a timesheet for the same period. Auditors identified five instances of such double entry during audit testing. In addition, the contract did not define the term "overtime" to mean time worked on a weekly, monthly, or annual basis. However, the recent contract renewal does define "overtime" as hours worked in excess of 40 hours per week.	\$143,800
Payroll charges	These fiscal year 2000-2002 payroll charges could not be traced from timesheets to hours charged. Timesheets associated with \$132,100 of these payroll charges were not provided by the established deadline, and timesheets associated with \$4,300 of these payroll charges contained errors that prevented tracing the timesheets to the hours charged.	\$136,400
Third-party transactions	The Department should review these transactions because the contractor did not provide sufficient supporting documentation to determine whether (1) the associated expenses related to the TexasOnline project or (2) travel expenditure criteria established in the contract was applied to subcontractors.	\$125,100
Mark-up charges	These mark-up charges were associated with purchases the contractor could have made, but did not make, through the Department's master contracts. The TexasOnline contract requires the contractor to use the Department's master contracts when the items purchased cannot be purchased less expensively elsewhere. The contract prohibits the contractor from adding mark-up to items purchased through state master contracts.	\$46,800

Expenditures Requiring Further Review Identified During This Audit		
Expenditure Type	Reason Expenditure Should be Reviewed	Amount
Travel charges	The Department should review these transactions because certain travel expenses the contractor charged to the contract did not comply with contract requirements. Auditors identified approximately one-half of these transactions as needing further review because the contractor did not have adequate supporting documentation as required by the contract.	\$19,700
Payroll charges	The Department should review these payroll charges because they were associated with instances in which more hours were charged to TexasOnline than to the contractor's corporate office payroll. Five of 20 (25 percent) of the corporate timesheets tested showed more hours charged to TexasOnline than to the contractor's corporate office.	\$8,000
Total		\$1,299,200

In addition to testing expenditures, auditors also conducted an inventory of TexasOnline assets. The contractor experienced difficulty locating a number of assets over a period of several months. After most of the initial inventory discrepancies were eventually resolved, the discrepancies that remained did not represent a significant percentage of the \$7.6 million in TexasOnline hardware and software. However, this process highlighted a need for increased monitoring of assets so that the Department has an awareness of how assets purchased for TexasOnline are being used. In addition, the State will assume ownership of these assets after the contractor breaks even.

Auditors also noted that the contractor is not reconciling its asset inventory with its general ledger. Performing this reconciliation would help to identify and correct inventory discrepancies in a prompt fashion.

The Department's September 2005 Renewal of the TexasOnline Contract Significantly Strengthened the Contract's Provisions

In June 2005, the State Auditor's Office provided suggestions based on audit fieldwork for strengthening contract provisions pursuant to a rider in the General Appropriations Act (see text box). In September 2005, the

Excerpt from
Rider 11, Page I-64,
General Appropriations Act
(79th Legislature)

It is the intent of the Legislature that the Department of Information Resources with the advice of the Legislative Budget Board and the State Auditor's Office negotiate a contract for the TexasOnline Project as authorized by Sec. 2054.252(d), Government Code.

Department added several new contract provisions that addressed a variety of contract weaknesses, including some of the provisions suggested by the State Auditor's Office and the Legislative Budget Board. Specifically, it added provisions to:

- Specify a date by which the contractor will break even. Under the old contract, the State would begin receiving 50 percent of TexasOnline net revenue when the TexasOnline contractor broke even and recovered its costs; however, exactly when that would occur was not specified. The September 2005 contract renewal included a provision stating that on December 31, 2006, the contractor will write off any unrecovered investment in TexasOnline and break even.¹ As a result, the State will begin to receive 50 percent of TexasOnline net revenue and assume ownership of TexasOnline assets no later than that date.
- Be more explicit about when the State would assume ownership of TexasOnline assets. The September 2005 contract renewal specifies that ownership of assets will be transferred to the State when the TexasOnline contractor breaks even. Under the old contract, ownership of assets was transferred to the State after contract termination, which would not necessarily coincide with the date on which the contractor broke even.
- Ensure that the State could have access to the TexasOnline contractor's payment engine if the contract is terminated. Before adding this provision, there were no assurances in the contract that the State will have continued access to that payment engine if the contract is terminated (the payment engine is the mechanism through which TexasOnline collects payments and fees).
- Tighten the process for the Department's approval of certain contractor actions. The September 2005 contract renewal requires that the Department's executive director approve the TexasOnline budget in writing and requires prior written Department approval for all contractor rates. It also removed a provision that specified the Department had implicitly approved subcontractors if it provided no comment. Prior to this change, the

¹ One existing project and any new projects will not be considered in determining the breakeven point for TexasOnline as a whole. Instead, each will have its own breakeven point, and the State will share net revenue associated with those projects after the contractor has recovered its cost for each project.

contract specified that the Department was considered to have approved the contractor's actions in these areas if it had not provided comment within specified time periods.

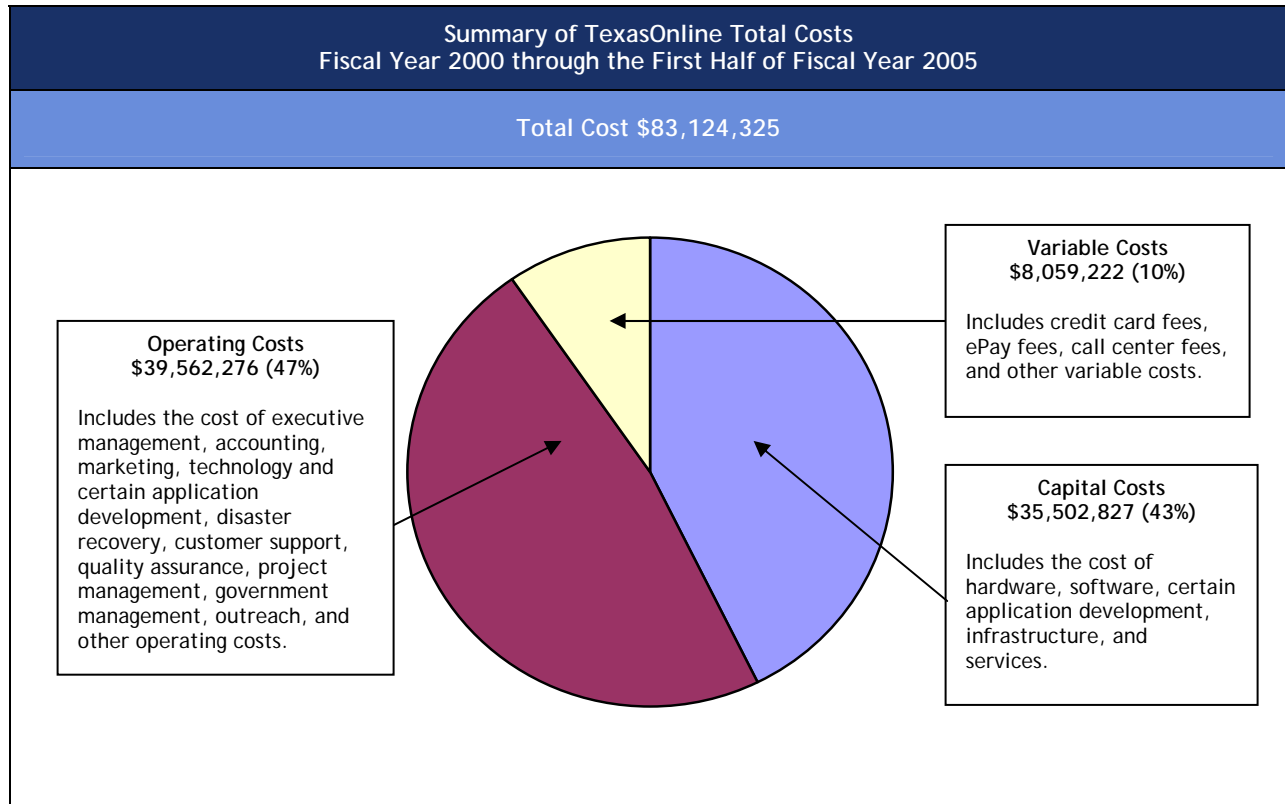
- Specify that the contractor charge a 7 percent mark-up charge on certain third-party invoices, rather than the 6-9 percent range of mark-up charges the TexasOnline contractor was formerly allowed to charge. This change eliminated incentive for the contractor to split invoices and charge more for markup. The old contract permitted the contractor to charge markups ranging between 6 to 9 percent of the purchase price, and the mark-up percentage decreased as the invoice amount increased. Auditors tested two sets of invoices and determined that, for one set of invoices, the contractor had split the cost of one service totaling \$100,000 among six invoices that were all dated the same date. This increased the mark-up charges and, therefore, increased the costs to TexasOnline by \$2,000.
- Add specificity regarding allowable and unallowable costs that could be charged to TexasOnline. This change strengthened contractor accountability because the TexasOnline contractor is now required to adhere to the same standard of fiscal responsibility to which state agencies must adhere. In addition, the September 2005 contract renewal required the contractor to obtain the Department's written approval for any purchases exceeding \$10,000.
- Require the TexasOnline contractor to maintain supporting documentation for its expenditures. The prior contract did not require the contractor to maintain supporting invoices, receipts, or other documentation for any transactions other than travel expenditures. The September 2005 contract requires the contractor to retain sufficient documentation to prove that expenses are "necessary and fiscally responsible."
- Require the TexasOnline contractor to insert language in its contracts with local governments that require the local governments to pay any unrecovered costs if they discontinue participating in TexasOnline. Local governments' TexasOnline applications are supposed to be self-funded. However, when certain local governments discontinued their participation in TexasOnline, the State was left with \$495,000 in unrecovered costs.
- Require the contractor to consult with the Department when developing proposals for TexasOnline and maintain separate accounting data for each new TexasOnline project. Prior to this improvement, the contractor could increase costs by initiating proposals for new applications, and the only control the Department had to oversee this process was the TexasOnline budget, which limits the contractor's expenditures. Additionally, the contractor could previously account for new projects in a manner that made it difficult to track some expenses from the proposal stage to the TexasOnline general ledger.

- Define certain key contract terms used in calculating the contractor's breakeven point. The September 2005 contract renewal agreement added explicit definitions of terms used in calculating the TexasOnline contractor's breakeven point. Clarifying these terms was beneficial because it added more clarity about when the contractor will have recovered its costs and, therefore, when the State will begin receiving 50 percent of TexasOnline net revenue and assume ownership of TexasOnline assets.
- Prohibit the contractor from hiring certain individuals who may have a conflict of interest. The September 2005 contract renewal prohibited the contractor from hiring (1) Department employees immediately after they leave the Department or (2) individuals who are currently employees of the Department. Adding these provisions helped to preserve the arms-length relationship between Department employees and the contractor.
- Require marketing plans with overall objectives, detailed strategies, time lines, and budgets. The September 2005 contract renewal modifies the requirements related to the contractor's marketing plan to include specific elements and frequency. The contractor must now develop an annual marketing plan, and that plan must include overall objectives, detailed strategies, time lines, and budgets. Some of these items were not included in the two previous marketing plans developed for TexasOnline.

TexasOnline Costs and Revenues

Figure 1 summarizes the costs of TexasOnline since its inception, and Table 2 on the following page provides detailed information on those costs.

Figure 1



Source: Calculated from information in the TexasOnline contractor's general ledger

Table 2

TexasOnline Costs Fiscal Year (FY) 2000 through the First Half of Fiscal Year 2005							
Cost Category	FY 2000	FY 2001	FY 2002	FY 2003	FY 2004	First Half of FY 2005	Total
Capital Costs							
Hardware	\$ 753,595	\$ 687,895	\$1,378,943	\$ 1,042,674	\$ 92,536	\$ 26,656	\$ 3,982,299
Software	180,262	1,212,192	1,133,716	927,529	186,542	14,689	3,654,930
Application Development	950,298	1,815,178	2,405,585	2,495,525	546,891	89,767	8,303,244
Infrastructure and Services	1,320,019	3,440,021	5,030,809	5,821,992	3,069,926	879,587	19,562,354
Total Capital Costs	\$3,204,174	\$7,155,286	\$9,949,053	\$10,287,720	\$3,895,895	\$1,010,699	\$35,502,827
Operating Costs							
Executive Management	\$ 0	\$ 251,177	\$ 1,231,815	\$ 973,280	\$ 1,246,137	\$ 440,703	\$ 4,143,112
Accounting and Finance	0	288,187	656,037	1,289,355	840,586	294,779	3,368,944
Marketing and Public Relations	0	609,912	799,268	710,164	789,551	191,977	3,100,872
Technology Development	0	0	471,246	538,003	399,651	204,902	1,613,802
Application Development	0	131,205	446,943	1,195,997	1,031,243	319,827	3,125,215
West Texas Disaster Recovery and Operations Center (DROC)	0	1,329,346	1,894,301	2,884,308	3,953,426	2,114,307	12,175,688
Customer Support	0	0	308,189	994,200	772,915	427,630	2,502,934
Application Development Quality Assurance	0	0	0	472,901	510,817	103,048	1,086,766
Project Management	0	479,591	2,066,993	1,086,943	2,948	0	3,636,475
Government Management	0	0	0	0	947,308	215,301	1,162,609
Outreach for New Service	0	0	0	1,728,240	1,125,642	210,333	3,064,215
Other	0	0	2,018	113,442	258,639	207,545	581,644
Total Operating Costs	\$ 0	\$3,089,418	\$7,876,810	\$11,986,833	\$11,878,863	\$4,730,352	\$39,562,276
Variable Costs							
Credit Card Fees	\$ 0	\$ 0	\$ 389,751	\$ 987,249	\$ 2,012,100	\$ 1,180,230	\$ 4,569,330
ePay Fees	0	0	98,544	449,661	1,143,387	653,490	2,345,082
Call Center Fees	0	80,792	151,761	194,133	149,127	9,207	585,020
Other	0	0	139,664	216,995	119,401	83,730	559,790
Total Variable Costs	\$ 0	\$80,792	\$779,720	\$1,848,038	\$3,424,015	\$1,926,657	\$8,059,222
TOTAL COST	\$3,204,174	\$10,325,496	\$18,605,583	\$24,122,591	\$19,198,773	\$7,667,708	\$83,124,325

Source: Calculated from information in the TexasOnline contractor's general ledger

Table 3 summarizes TexasOnline gross revenues from the inception of TexasOnline in 2000 through the first half of fiscal year 2005.

Table 3

Summary of TexasOnline Gross Revenues Fiscal Year 2000 through the First Half of Fiscal Year 2005 ^a					
Fiscal Year	Contractor's Share of TexasOnline Gross Revenues ^b		State's Share of TexasOnline Gross Revenues		Total Gross Revenues
	% Share	Amount	% Share	Amount	
Fiscal year 2000	100% of local revenues 100% of state revenues	\$0.00	0%	\$0.00	\$0.00
Fiscal year 2001	100% of local revenues 100% of state revenues	\$1,528,525.57	0%	\$0.00	\$1,528,525.57
Fiscal year 2002	100% of local revenues 90% of state revenues	\$7,085,941.50	10% of state revenues	\$692,086.00	\$7,778,027.50
Fiscal year 2003	100% of local revenues 90% of state revenues	\$19,660,193.48	10% of state revenues	\$1,878,232.00	\$21,538,425.48
Fiscal year 2004	100% of local revenues 90% of state revenues	\$23,802,051.52	10% of state revenues	\$2,388,804.00	\$26,190,855.52
First half of fiscal year 2005	100% of local revenues 90% of state revenues	\$12,127,213.93	10% of state revenues	\$1,229,987.68	\$13,357,201.61
Totals		\$64,203,926.00		\$6,189,109.68	\$70,393,035.68
^a In fiscal year 2006, the contractor retains 100 percent of gross revenues; in fiscal year 2007, the contractor retains 80 percent of gross revenues and the State receives 20 percent. ^b The contractor's gross revenues are not equal to the amount of profit that the contractor has earned. This figure does not take into account the expenditures the contractor has made.					

Source: Calculated from information in the TexasOnline contractor's general ledger

Additional Issues for the Department's Consideration

During this audit, the following additional issues for the Department's consideration were identified:

- At the August 2005 meeting of the Department's governing board, there was discussion about the rate of return the TexasOnline contractor will earn over the life of the contract. The contractor's calculation does not recognize the interest it will earn for loaning money to the State as part of its total return on investment.
- For future contracts, including future TexasOnline contracts, the Department may wish to consider using payment methodologies other than those that are cost-based. Cost-based payment methodologies require relatively higher levels of monitoring because they require the Department to examine its contractors' costs. The Texas Building and Procurement Commission's *State of Texas Contract Management Guide*, Version 1.1, discourages the use of cost-plus contracts (a type of contract with a cost-based methodology) because such contracts create a potential disincentive for the contractor to minimize costs.

Objective, Scope, and Methodology

Objective

The audit objective was to determine whether the Department and the TexasOnline Authority² protect the State's financial interests by adequately monitoring the TexasOnline contract to ensure that:

- Contractor performance is adequately monitored to ensure compliance with the terms of the contract and contract renewal agreements.
- Opportunities to strengthen the contract are pursued during contract negotiations.
- The contractor provides accurate and useful financial reports.
- Revenue due to the State is monitored, verified, and deposited into the State Treasury in a timely manner.³

Scope

The audit scope covered all costs associated with and revenues earned by TexasOnline from its inception in May 2000 through February 2005.

Methodology

The audit methodology included conducting interviews, collecting and reviewing information, verifying inventory, and performing tests and analyses against established criteria.

Other Information

We conducted fieldwork from August 2004 through August 2005. This audit was conducted in compliance with generally accepted government auditing standards, which require independence in both fact and appearance.

An immediate family member of the State Auditor is registered with the Texas Ethics Commission as a government relations employee of a firm that conducts lobbying efforts on behalf of a contractor included in the scope of this audit. This condition could be seen as potentially affecting our independence in reporting results related to this contractor. However, we proceeded with this audit as required by the *State Auditor's Office Audit Plan – Calendar Year 2004*, approved by the Legislative Audit Committee.

² During the course of this audit, the TexasOnline Authority, which had oversight authority over TexasOnline, was abolished by House Bill 2048 (79th Legislature, Regular Session), and its duties were reassigned to the Department.

³ We did not pursue the portion of this objective that was related to timeliness because our initial audit work indicated that this was a low-risk area.

The State Auditor recused himself from this audit, and the audit has been supervised, reviewed, and approved by an Assistant State Auditor, who has signed this report. The condition did not affect our audit conclusions.⁴

⁴ Lara Laneri Keel is registered with the Texas Ethics Commission as a lobbyist. Her list of clients is a matter of public record and may be obtained from the Texas Ethics Commission.

Management's Responses



DEPARTMENT OF INFORMATION RESOURCES

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October 28, 2005

LARRY A. OLSON
Chief Technology Officer
State of Texas

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Ms. Susan Riley, CPA
Assistant State Auditor
The State Auditor's Office
1501 North Congress Avenue
Austin, Texas 78701

Dear Ms. Riley:

We appreciate the hard work and cooperation that the State Auditor's staff demonstrated during the audit of the TexasOnline contract and your office's suggestions for improvement of the contract and contract monitoring process.

We agree with the recommendations in the audit and, in addition to strengthening the contract in the Second Renewal Agreement as noted in your report, we have taken the following actions to address the recommendations:

- In November 2004, the Department of Information Resources (DIR) implemented a monthly time sheet review and analysis process to identify and remediate variances from approved hourly contract rates and personnel.
- DIR is currently conducting interviews to hire a new employee whose primary responsibilities include TexasOnline contract monitoring for financial compliance.
- Within the past two weeks, DIR staff and the contractor have developed written procedures to document communications between the two parties related to review and approval of expenditures, including changes in key personnel, billing rates, and/or fees.
- DIR has amended the *DIR Contract Management Standards Manual* to clarify that the intention is to conduct quarterly reviews of contractor financial activity. In addition to the quarterly reviews, annual financial audits will be performed by an independent auditor in compliance with HB 2593.
- DIR has initiated independent reviews of projected revenues and expenditures in opportunity proposals prior to approval of new TexasOnline projects by the DIR Executive Director.

DIR will implement your office's recommendations according to the following schedule:

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Visit www.TexasOnline.com, the Official Web Site of the State of Texas

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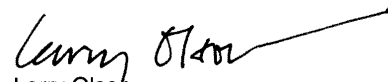
RECOMMENDATIONS	ACTION TO BE TAKEN	ACTION COMPLETION DATE	PRIMARY RESPONSIBLE PARTY
Follow up on expenditures identified during this audit as requiring further review; deduct those that violate the contract from total TexasOnline costs	Review expenditures to determine if they violate the contract	Feb 2006	Chief Financial Officer
Perform quarterly audits of the TexasOnline contractor as required by DIR Contract Management Standards Manual	Quarterly reviews will be performed and results will be reported directly to DIR's Executive Director	Manual amended 10/25/2005; quarterly reviews will begin in Dec 2005	Chief Financial Officer
Formalize and document the TexasOnline contract monitoring program; disseminate information to all staff involved in contract monitoring; train staff to carry out monitoring responsibilities	Disseminate manual to all affected staff; train staff to carry out monitoring responsibilities	Manual has been disseminated; staff training will be completed by Jan 2006	Enterprise Applications Services Manager and Chief Financial Officer
Retain supporting documentation for all key management decisions	Develop written procedures to ensure that all review and approval is documented and retained	Procedures have been drafted; the draft will be completed and implemented by Jan 2006	Enterprise Applications Services Manager and Chief Financial Officer
Obtain explicit vendor approval of the transfer of software ownership from the contractor to the state free of charge	Confirm that assignability language is included in license agreements	Feb 2006	General Counsel
Contractor should provide information from contractor related to components of salary, overhead, and general and administrative costs to assist in monitoring costs	Obtain components of salary, overhead, and general and administrative costs	Feb 2006	Chief Financial Officer
Establish and enforce procedures related to non-system performance contract non-compliance	Procedures will be established	Feb 2006	Enterprise Applications Services Manager

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We agree that all future contracts for operation and management of TexasOnline should be service-based rather than cost plus-based.

Again, we appreciate the assistance that your office has provided in identifying ways to strengthen the contract and improve contract monitoring.

Sincerely,


Larry Olson