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.

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

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 agencies[1] (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.

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[1] In 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	• 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.	• 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	Fixed rate is established using one of these methods: • Analysis of cost information submitted by provider • Based on factors other than cost such as prevailing Medicaid rates (fee-for-service) • Competitive negotiation	Reimbursement amount is based on analysis of contractor's proposed budget during contractor selection or renewal process.
Agency Oversight	Focuses on the delivery of quality services, not the appropriateness of contractor expenditures. 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.	Fiscal oversight focuses on verifying that expenditures were: • Allowable based on guidelines included in the contract • Reasonable and necessary for the operation of the program • In accordance with approved budget Expenditures which do not meet this criteria must be reimbursed to the funding agency.

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.

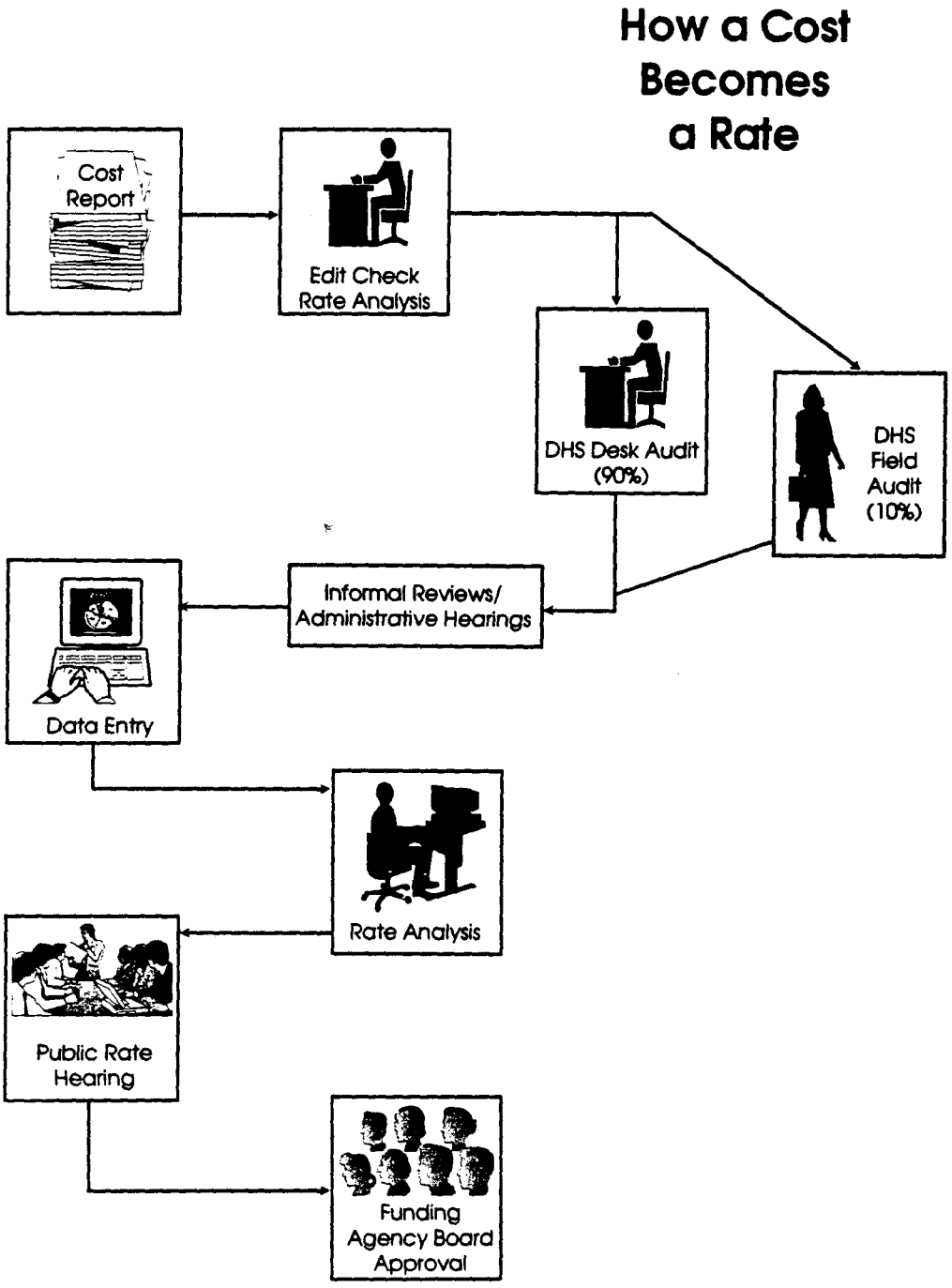
Under this method of rate-setting, all providers are paid the same rate for the same level of services, even if costs differ. Variations in costs of doing business in different parts of the State are not taken into consideration, nor are differences between for-profit and non-profit providers considered. 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



on vendor payments for such things as submitting an unacceptable cost report

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 unauditable 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,