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

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

- The HIV/AIDS Program administered by TDH reviews proposed budgets for reasonableness based on experience with other providers. However, TDH does not maintain any documentation that identifies the costs to provide services. *During our review of provider's proposed budgets, we noted three instances in which contractors received more funding than requested in their proposed budget.*

- Although TDH reviews budgets submitted by Title X (Family Planning) program for reasonableness, there are no written guidelines on what constitutes reasonableness. In reality, maximum contract amounts are set regionally based on the perceived need or availability of funds.

- At DPRS, the budgets for adoption brokers, in-home casework and case management contracts, and preparation for adult living contracts are set regionally with only limited guidance from DPRS. Although it is important to allow the regions a certain amount of flexibility in setting budgets so that differences in geography and demographics can be recognized, without providing standard guidelines regarding the maximum amounts which should be paid for services, DPRS has no assurance that it is paying a reasonable amount for these services. For example, we found that the provider of the adoption broker contract was paid a 10 percent administrative fee which was arbitrarily established by the regional office without any analysis of the costs incurred by the provider.

Section 2-C:

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

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

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

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

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

- We reviewed one HIV/AIDS provider and found $102,299 in questioned costs. Examples of the questioned costs include the following:

  - Payments of $7,923 made to a related party for purchases of equipment made without the benefit of a competitive procurement process and a large number of questionable telephone repair services such as turning the phone ringer on and plugging a power cord into the wall.
  - $10,000 in purchases made on the last day of the contract. The items purchased were not disbursed to clients during the contract period.
  - $1,780 in expenditures which were overallocated to TDH and $3,115 in payments made without the documentation required by program standards.

- At another HIV/AIDS provider, we found over $5,400 of expenditures which were made without obtaining the documentation required by the contract.

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

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

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

Section 3:

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

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

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

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

Section 3-A:

Enrollment Process Limits Objectivity of Contractor Selection Process

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

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

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

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

Section 3-B:

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

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

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

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

Section 3-C:

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

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

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

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

Section 4:

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

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

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

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

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

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

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

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

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

- Develop a system of contract management by health and human services agencies that:

    1. ensures fiscal and programmatic accountability in all contracts, including adequate sanctions to ensure compliance

    2. provides appropriate consistency across agencies in contract procurement methods, language and format, management and monitoring, and auditing and evaluation activities

    3. maximizes efficiencies across agencies

- Describe the system concretely and concisely in order to be able to educate contractors, the public, and governmental oversight entities about the system.

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

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

Section 5:

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

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

- **Cost Settlements -** In reviewing other states' mental health programs contracting processes, TDMHMR's Internal Audit Department found that six of nine states' contracts required a cost settlement at the end of each fiscal year. While the form of the cost settlement varies from state to state, this requirement allows states to recover any funds distributed to a contractor which are in excess of the actual cost incurred to provide the service. For example, in New York, if a county/provider has spent less than what was agreed to in the contract, the unspent funds are recouped by reducing the next payment to the county/provider. On the other hand, in New Hampshire, three percent of the total contract funds are withheld from provider payments until a cost settlement is conducted at the end of the fiscal year.

- **Detailed Review of Caps on Administrative Costs -** TDMHMR's Internal Audit Department also found that most states surveyed carefully monitor the indirect costs charged to state programs and that some states limit the amount of funds provided for administrative costs or refuse to fund providers' indirect costs. Caps have also been considered for other programs. For example, in 1994 a consultant reviewed New Mexico's rate-setting process for children's residential services and recommended that the state cap administrative expenses at 15 percent of total costs.

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

- In Missouri, the majority of contracts are awarded through an open enrollment process with unit rates established by the legislature based on recommendations submitted by the Department of Social Services and the provider industry.

- In Michigan, the Department of Social Services began moving away from unit rates based on cost information to a more competitive contract award process.

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

- In Pennsylvania, responsibility for evaluating provider costs, setting rates, and assuring the best possible rates rests at the county level. County rate-setting processes vary depending on the size of the county and the number of counties serviced by each provider. In counties with larger client populations, the counties control the rate-setting process. In counties with smaller client populations, the providers control the process and simply notify the county what their rate is.

- In California, rates are based upon the results of a cost study of actual, allowable, and reasonable costs which was conducted in 1985. Each year, the state increases rates by a California inflation factor. (Rates have also been adjusted for increases in the minimum wage.)

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

OVERALL RECOMMENDATIONS:

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

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

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

We recommend that the funding agencies consider the following:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Section 6:

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

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

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

Figure 5
Summary of Department Contracts Reviewed

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

Section 6-A:

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

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

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

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

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

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

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

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

- One contractor made either inappropriate or unsupported expenditures of $267,292. Examples included payment of management and consulting fees (some of it to related parties), travel expenses, advertising expenses, and other administrative expenses for which there was no documentation to support that the expenditures were related to the objectives of the program. When questioned about the nature of these expenditures, the provider did not seem concerned and simply stated, "I guess we didn't do a very good job."

- One provider made over $61,805 in inappropriate or unnecessary expenditures such as entertainment, interest on borrowed capital, unsupported payments to consultants, and improper allocation of employees' salaries.

- One provider spent over $13,000 on flyswatters and calendars to advertise their services.

Section 6-B:

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

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

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

- During the contract year reviewed, the four family members, along with the administrator, together received $1,099,655 in total compensation. (The company received total revenues of $13,954,751, or 89 percent of its revenue from DHS.)

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

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

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

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

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

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

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

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

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

- **Currently, it is not mandatory that providers attend training on cost report preparation.** The providers receive explicit instructions for preparing the cost report and notification of training classes, but providers are not required to attend. DHS has proposed rules which will make cost report training mandatory for all providers. During our review of providers, we found that there was a lack of accounting experience at the provider level which also raises concerns about the quality and accuracy of information included on the cost report.

- **There are no standards for computing costs such as administrative expenses.** Without defining standards for certain costs, DHS cannot compare costs between providers and evaluate efficiency. For example, our analysis of fiscal year 1993 cost report data for the Nursing Facility Program found that total administrative expenses ranged from 74 percent of total expenses to two percent of total expenses. For the primary home care program, total administrative expenses ranged from 56 percent to five percent of total expenses. This wide variation appears to indicate that some providers are more efficient than others, but without established standards or definitions of administrative expenses, a true comparison cannot be made.

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

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

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

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

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

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

- DHS should consider using uniform regional boundaries in H.B. 7, 72nd Legislature, or other appropriate demographic criteria to stratify the reimbursement rates paid to nursing facilities.

- DHS should increase the number of annual field audits performed (from 10 percent).

- DHS should develop its audit plan based on risk assessments of the cost reports.

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

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

- The Title XX Home Delivered Meals Program uses competitive negotiation to establish rates. Although this method allows rates to be tailored to meet the needs of each location, the accuracy of the negotiated rates depends upon the skills and knowledge of DHS' regional negotiators. As the agency has not prepared written policies and procedures to assist regional contract managers in negotiating the rates, variation in rates may be based on negotiator skills rather than on true differences in costs to provide services.

- The Child Care Management Services (CCMS) Program establishes rates for the child care direct services portion of its contracts. (Funding for the administrative portion is cost reimbursement.) Rates are based on a biennial market survey of child care facilities throughout the State. The maximum reimbursement rates are set based on the 75th percentiles of market rates, as determined by a survey conducted by The University of Texas. The rate-setting process creates a possibility of 32 different rates for each provider.

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

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

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

Section 6-C:

Federal Requirements Limit Use of Competition in Contractor Selection Process

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

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

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

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

Recommendations:

We recommend that the Department consider the following:

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

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

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

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

Section 7:

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

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

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

Figure 6
Summary of DPRS Contracts Reviewed

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