

Figure 8
Summary of TDMHMR Contracts Reviewed

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

Section 9-A:

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

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

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

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

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

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

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

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

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

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

Section 9-B:

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

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

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

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

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

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

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

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

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

Section 9-C:

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

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

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

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

Recommendations:

TDMHMR should consider the following:

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

Summary of Responses by Affected Agencies

State Auditor Comments on Agency Responses

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

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

Health and Human Services Commission

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

Department of Human Services

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

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

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

Department of Protective and Regulatory Services

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

Texas Department of Health

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

Texas Department of Mental Health and Mental Retardation

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

management's Responses



TEXAS HEALTH AND HUMAN SERVICES COMMISSION

MICHAEL D. MCKINNEY, M. D.
COMMISSIONER

January 25, 1996

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

Dear Mr. Alwin,

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

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

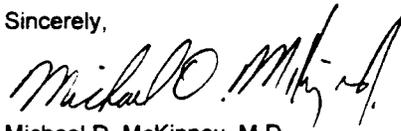
I would like to make a point of clarification about the role of the Health and Human Services Commission in rate setting. As your report acknowledges, we do not set any rates. As single state agency for Medicaid, we approve Medicaid rates set by operating agency boards. For other services, we do not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

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

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

Sincerely,



Michael D. McKinney, M.D.

MM:MH:ls

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Department
Human^{of} Services

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January 31, 1996

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

Dear Ms. Reed:

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

Sincerely,



Burton F. Raiford

BFR:cfl

Texas Department of Human Services Responses

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

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

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

Basic Rate Determination Issues

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

Key Points of Department Response

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Electronic Benefits Transfer (EBT) Unit Rate Contract

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

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

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

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

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

Responses to Specific Audit Report Recommendations

- **Contracts**

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

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

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

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

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

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

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

- **Strengthen reimbursement methodologies**

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

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

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

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

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

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

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

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

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

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



TEXAS DEPARTMENT OF PROTECTIVE AND REGULATORY SERVICES

EXECUTIVE DIRECTOR

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February 5, 1996

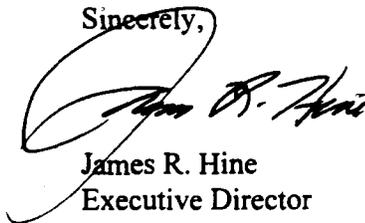
Ms. Cindy Reed
 State Auditor's Office
 Two Commodore Plaza
 206 East Ninth Street
 Austin, TX 78701

Dear Ms. Reed:

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

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

Sincerely,



James R. Hine
 Executive Director