



# STATE OF TENNESSEE COMPTROLLER OF THE TREASURY

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## Review of Tennessee's Contract Monitoring and Management Systems

Performance Audit Report

September 2011

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**Comptroller of the Treasury**



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September 28, 2011

The Honorable Bill Haslam, Governor  
and  
The Honorable Bill Ketron, Senator, Chair  
The Honorable Curtis Johnson, Representative, Vice Chair  
Fiscal Review Committee  
and  
Members of the General Assembly  
State Capitol  
Nashville, Tennessee 37243  
and  
The Honorable Mark A. Emkes, Commissioner  
Department of Finance and Administration  
State Capitol  
Nashville, Tennessee 37243

Ladies and Gentlemen:

We have conducted a performance audit of the state's contract monitoring and management systems for the period July 1, 2008, through June 30, 2009.

We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our audit results based on our audit objectives. Management of the Department of Finance and Administration and other state entities involved in contract monitoring and management is responsible for establishing and maintaining effective internal control and for complying with applicable laws, regulations, and provisions of contracts and grant agreements.

Our audit disclosed certain issues which are detailed in the Audit Results section of this report. The Department of Finance and Administration's management has responded to the audit issues; we have included the department's response in Appendix 4. We will follow up the audit to examine the application of the procedures instituted because of the audit issues.

September 28, 2011  
Page Two

We have reported other less significant matters involving internal control to management of the Department of Finance and Administration and other state entities in separate letters.

Sincerely,

A handwritten signature in black ink that reads "Arthur A. Hayes, Jr." in a cursive style.

Arthur A. Hayes, Jr., CPA  
Director

AAH/KBT/sah  
09/097

# **Performance Audit Review of Tennessee's Contract Monitoring and Management Systems**

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## **EXECUTIVE SUMMARY**

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### **THE STATE LACKS EFFECTIVE OVERSIGHT OF CONTRACTS WHICH REPRESENT BILLIONS OF DOLLARS A YEAR IN STATE EXPENDITURES**

Each year the State of Tennessee contracts with thousands of subrecipients and vendors to procure billions of dollars of goods and services. State departments and agencies (“entities”) are responsible for monitoring and managing these contracts to ensure

- compliance with laws, regulations, and the provisions of contracts or grant agreements including the achievement of contract performance goals;
- efficiency and cost-effectiveness; and
- service provider accountability and results.

With effective and efficient contract monitoring and management systems, the state can better protect taxpayer funds from ineffective or inefficient contract management as well as from error, fraud, waste, and abuse.

During this audit, we sought to identify areas of the state's contract monitoring and management systems that need improvement and to recommend that officials in the Department of Finance and Administration (F&A) and in the state's newly established Procurement Office use this information to improve the contract monitoring and management systems, which are critical elements of the state's process for procurement of goods and services through subrecipient and vendor contracts. Our intent was to review each system as a whole; we did not seek to identify areas of noncompliance at specific state entities.

To achieve our objectives, we interviewed officials at F&A; reviewed relevant laws, rules, and policies; and interviewed officials and performed testwork at eight selected state entities that administered both subrecipient and vendor contracts to evaluate the actual operation of the contract monitoring and management systems compared to the design of the systems. Our work focused on the fiscal year July 1, 2008, through June 30, 2009. We conducted our audit in accordance with generally accepted government auditing standards.

## **AUDIT RESULTS**

Based on our interviews, reviews, and testwork, we found that the state relies completely on management at the individual state entities to comply with Department of Finance and Administration Policy 22, “Subrecipient Contract Monitoring,” and with the requirements of Chapter 0620-3-8 of the *Rules of Department of Finance and Administration*, “Contract Management and Subrecipient Contract Monitoring.”

We also found that officials at F&A do not have an effective oversight mechanism to ensure that state entities are complying with Policy 22 or the rules. As we note in the report, since 2004, our office has reported numerous monitoring deficiencies in state entities during other audits. These deficiencies emphasize the need for oversight that can identify problem areas and implement corrective actions in the contract monitoring and management process that will ensure taxpayer funds are protected.

With regard to subrecipient contract monitoring, we noted that although the Office of Consulting Services (OCS) in the Department of Finance and Administration reviews and approves the entities’ subrecipient monitoring plans as required by Policy 22, OCS does not

- routinely verify that each entity with a subrecipient contract submits a monitoring plan,
- verify the information entities report in the subrecipient monitoring plan,
- routinely determine if state entities follow the submitted monitoring plan, or
- determine if entities verify that subrecipients took corrective action steps to address findings noted in subrecipient monitoring reports.

With regard to contract management, we did not identify any specific contract management issues.

## **OVERALL RECOMMENDATION**

Officials in the Department of Finance and Administration and in the state’s newly established Procurement Office (created by Section 4-56-104, *Tennessee Code Annotated*) should study the state’s contract monitoring and management systems to identify specific actions to address the oversight issues, and by October 1, 2012, report actions to be taken to the Comptroller of the Treasury, Fiscal Review Committee, and the newly formed State Procurement Commission (created by Section 4-56-102, *Tennessee Code Annotated*). State officials should ensure that changes to the current contract monitoring and management systems ensure that taxpayer funds used to procure goods and services through subrecipient and vendor contracts are used effectively and efficiently and are protected from error, fraud, waste, and abuse. In addition to the state’s development of an effective oversight mechanism, the chief executives of each state

entity should take direct responsibility for ensuring that their entity's respective subrecipient and vendor contracts are properly monitored and managed.

See Appendix 4 for the official response to this report from the Commissioner of the Department of Finance and Administration.

# Performance Audit Review of Tennessee's Contract Monitoring and Management Systems

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# **Performance Audit Review of Tennessee’s Contract Monitoring and Management Systems**

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## **INTRODUCTION**

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Each year the State of Tennessee contracts with thousands of subrecipients and vendors to procure billions of dollars of goods and services for the state and its citizens. The state and, more specifically, state departments and agencies (“entities”) are responsible for monitoring and managing these contracts to protect taxpayer funds.

To provide assurance that taxpayer funds used for contracts are protected, the state has two primary systems: a subrecipient monitoring system and a contract management system. This report describes the state’s current systems for contract monitoring and contract management, outlines our audit work, and details the issues we identified along with our recommendation. Our objective was to identify issues that impede the state’s effective and efficient use of subrecipient and vendor contracts to procure goods and services. Addressing these issues should enable the state’s policy makers to design and implement more effective and efficient systems while also managing the risks of error, fraud, waste, and abuse resulting from ineffective contract monitoring.

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## **AUDIT AUTHORITY**

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Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

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## **AUDIT OBJECTIVES**

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We had two objectives in our audit of the state’s subrecipient monitoring and contract management systems. Our first objective was to determine whether the subrecipient contract monitoring system facilitates state entities’ effective monitoring of subrecipient contracts to ensure compliance with laws, regulations, and the provisions of contracts or grant agreements and the achievement of contract performance goals. As part of our first objective, we also wanted to determine if there is an effective oversight mechanism to provide assurance that state entities are in fact monitoring their subrecipient contracts.

Our second objective was to determine whether the contract management system facilitates state entities' effective management of contracts to ensure procurement of goods or services based on efficiency, cost-effectiveness, and service provider accountability and results. In each objective, we sought to review and evaluate the system as a whole; we did not seek to determine if individual state entities were complying with applicable policies and rules.

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## **SCOPE AND METHODOLOGY**

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We reviewed the state's contract monitoring and management systems for the fiscal year July 1, 2008, through June 30, 2009. Our scope of work focused on the subrecipient contract monitoring and contract management systems as they impact the state as a whole rather than focusing on individual state entities.

In order to gain an understanding of how the state's current contract monitoring and management systems were designed to operate, we interviewed officials at the Department of Finance and Administration (F&A), and we reviewed relevant laws, rules, and policies. See Appendix 1 on page 17 for specific documents reviewed.

To determine how Tennessee's contract monitoring and management systems compared to the systems in other states, we interviewed officials in 15 states, including 10 other southeastern states, about how those states monitor and manage their contracts. See Appendix 1 on page 18 for a list of the states surveyed.

We interviewed entity officials and performed detailed audit procedures at eight selected Tennessee state entities that administered both subrecipient and vendor contracts to evaluate the actual operation of the subrecipient contract monitoring and contract management systems compared to the design of the systems. We then used our observations to draw conclusions about the effectiveness and efficiency of the systems. See Appendix 1 on page 18 for a description of our sample selection, the eight entities we selected, and the detailed audit procedures we performed at each entity.

We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our audit results based on our audit objectives.

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## BACKGROUND INFORMATION

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### CLASSIFICATION OF CONTRACTS

The state's service contracts are classified as either subrecipient contracts or vendor contracts depending on the nature of the business relationship with the contractor. The classification of contracts and the entities' responsibilities can be found in Section 0620-3-8-.03 of the *Rules of Department of Finance and Administration*, which is captioned "CONTRACT MANAGEMENT AND SUBRECIPIENT MONITORING-DISTINGUISHED." State entities determine which type of contract they will use in a particular situation. State entities are responsible for managing all subrecipient and vendor contracts that fall under that entity's control. Additionally, the entity must monitor each subrecipient contract. The specific characteristics of subrecipient and vendor relationships are detailed below.

#### Subrecipients

Policy 22 defines a subrecipient as a non-federal organization that expends state or federal funds or both received from the state to carry out a state or federal program. (The full text of Policy 22 and the related *Subrecipient Contract Monitoring Manual* are available at <http://www.state.tn.us/finance/rds/rdsPolicy.html>.) In general, management of a state entity classifies a contract as a subrecipient relationship when the state entity contracts with another organization to administer all or part of the state or federal program. For example, a department might contract with several subrecipients to distribute food to needy families instead of the state directly providing that service. Subrecipients exercise greater control in making eligibility determinations than do vendors. The state, through its Policy 22, requires state entities to monitor subrecipient contracts with the expectation that the monitoring efforts outlined in Policy 22 will adequately protect the taxpayers' funds from error, fraud, waste, and abuse. State entities must also manage subrecipient contracts in accordance with Chapter 0620-3-8 of the *Rules of Department of Finance and Administration*.

#### Vendors

Policy 22 defines a vendor as a dealer, distributor, merchant, or other seller providing goods or services necessary for the conduct of a program. For example, a department might contract with a vendor for consulting services. According to the Office of Management and Budget (OMB) Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations," in vendor contractual relationships, the vendor provides goods or services based on a competitive environment, and the vendor is not subject to state or federal compliance requirements. The state requires the contracting state entity to manage vendor contracts in accordance with Chapter 0620-3-8 of the *Rules of Department of Finance and Administration*.

## **CURRENT SUBRECIPIENT CONTRACT MONITORING SYSTEM**

Monitoring is management's review process to determine subrecipients' compliance with the requirements of state or federal programs, applicable laws and regulations, and stated results and outcomes. The monitoring process is intended to identify any areas of noncompliance with the expectation that subrecipients will take corrective action to ensure compliance with all requirements.

Department of Finance and Administration Policy 22 and the *Tennessee Subrecipient Contract Monitoring Manual*, created by F&A's Resource Development and Support Division, provide specific guidelines management of state entities must follow when monitoring their subrecipient contracts. F&A created Policy 22 in order to fulfill the requirements of Section 12-4-109(d), *Tennessee Code Annotated*, which states that the commissioner of F&A "shall develop regulations that define service contracting fundamentals, including, but not limited to, contract management and monitoring of vendors, grants, and subrecipient relationships." According to the statute, the regulations "shall, at a minimum, require the filing of the monitoring plan with F&A before any contracts are approved." F&A also developed Policy 22 to provide a tool that the state, through each of its state entities, can use to help ensure compliance with OMB Circular A-133, which requires the state to monitor activities of subrecipients and to ensure compliance with federal program and administrative requirements.

### **Subrecipient Contract Monitoring Plan**

Every October 1 each state entity expecting to fund subrecipient contracts must submit an annual subrecipient monitoring plan for review and approval to F&A's Office of Consulting Services. Generally, monitoring staff prepare the annual plans. The annual subrecipient monitoring plan outlines the monitoring activities the state entity plans to perform for the year following the submission of the plan. According to Policy 22, the plan must include the following components:

- a listing of the total subrecipient contract population of the entity;
- subrecipient contracts to be monitored during the current monitoring cycle;
- identification of whether the entity monitoring cycle is based on the state fiscal year or the federal fiscal year;
- sample monitoring guide or guides to be utilized for each state and or federal program to be monitored;
- a listing of the full-time equivalents and personnel classifications for all staff dedicated to monitoring activities;
- a program description of each state and or federal program being monitored;
- a risk assignment for each subrecipient and its related contracts;

- an explanation of the criteria used to assign risk to subrecipients and their related contract or contracts;
- a summary of findings from the previous monitoring year; and
- an explanation of the state entity's corrective action process.

### **Subrecipient Contract Monitoring Activities**

Subrecipient contract monitoring activities vary from entity to entity and from contract to contract because state entities may monitor their contracts with any method they deem appropriate as long as the entity staff monitor for compliance with the specific requirements of the contract, state or federal program, Title VI of the Civil Rights Acts of 1964, and if applicable, the core monitoring areas as defined in the OMB Circular A-133 Compliance Supplement. The current core monitoring areas include activities allowed or unallowed; allowable costs/cost principles; cash management; the Davis-Bacon Act; eligibility; equipment and real property management; matching, level of effort, and earmarking; period of availability of funds; procurement, suspension and debarment; program income; real property acquisition and relocation assistance; reporting; and special tests and provisions.

The monitoring methods and organizational structures may vary considerably across the state, but generally the state entity assigns subrecipient monitoring duties to specific staff. In larger agencies, the monitoring staff's only duty might be subrecipient monitoring, but most typically subrecipient contract monitoring is one of many duties of the monitoring staff. Policy 22 requires the state entity's monitoring staff to be independent of the staff members who are writing and overseeing the contract.

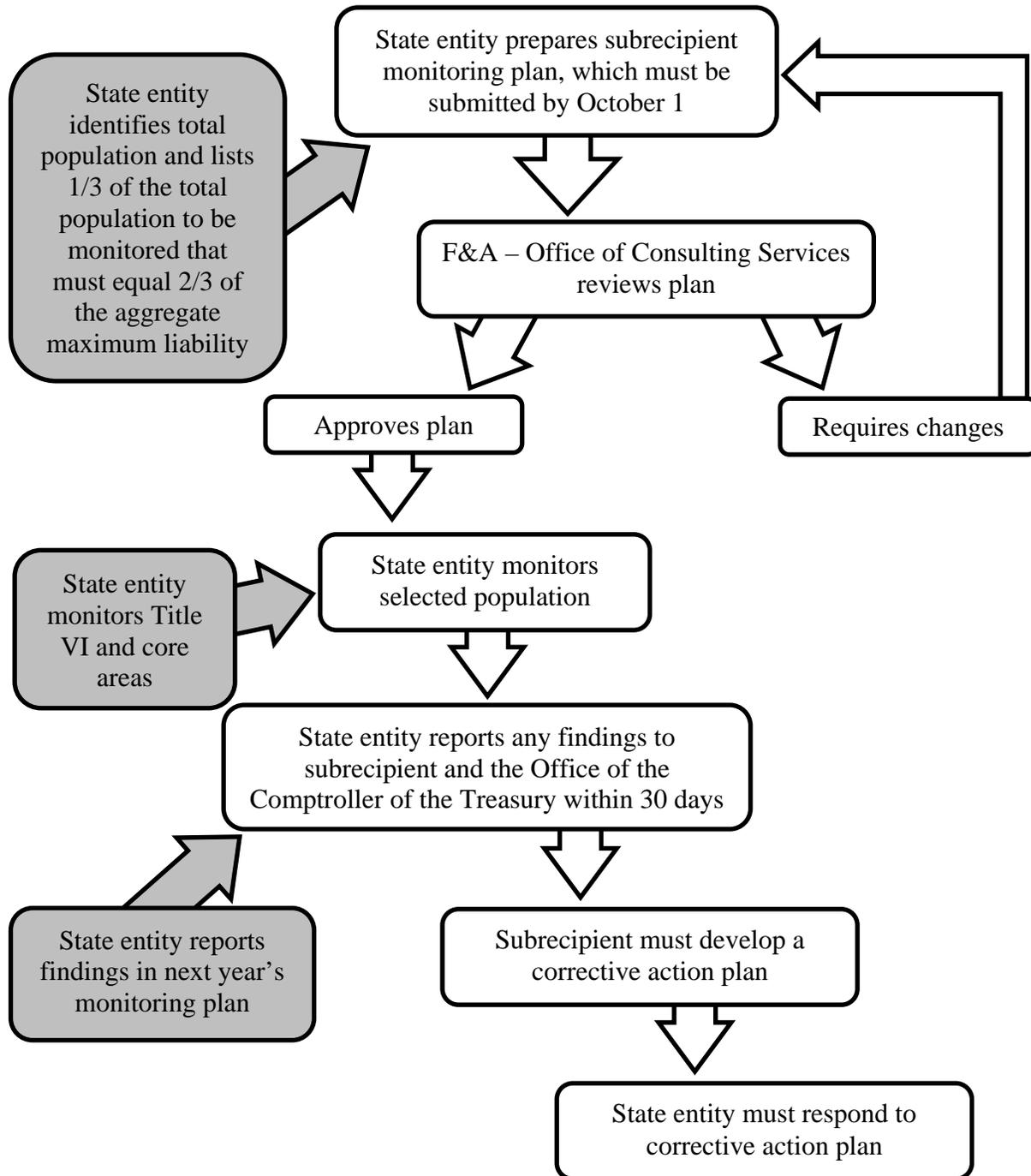
Policy 22 requires state entities to monitor a third of the total number of the entity's subrecipient contracts in effect during the fiscal year. According to Policy 22, the total number of contracts should not include the federally funded contracts the entity is already monitoring due to federal requirements. For example, if the state entity has 200 total contracts including 15 the entity has planned to monitor due to federal requirements, then the state entity should monitor a third of the 185 total remaining contracts. Additionally, the contracts that the entity selects to monitor must have a maximum liability of at least two-thirds of the aggregate maximum liability of the total contract population. Entities may need to monitor more than one-third of the contract population to fulfill the two-thirds stipulation. For example, if a state entity will have 120 contracts in effect during the upcoming fiscal year with an aggregate maximum liability of \$1,200,000, then that entity must monitor at least 40 contracts that equal a maximum liability of at least \$800,000.

State entities are required to monitor contracts based on the parameters of their annual subrecipient monitoring plan. However, an entity must revise the plan in the event of changes in the subrecipient contract population (e.g., new contracts or cancellation of contracts) or other events that would necessitate a change. Entities are required to document any changes made to the plan.

To illustrate the process, in a monitoring visit to a subrecipient contractor, the activities of the entity's monitoring staff might include a review of documentation to determine if the contractor verifies participant eligibility, is actually providing the services contracted for, and has complied with other terms of the contract. At the completion of each monitoring visit, Policy 22 requires state entities to issue a report to the subrecipient summarizing any findings or observations identified during the review within 30 business days after the completion of all fieldwork and to send copies of the monitoring reports to the Office of the Comptroller of the Treasury. Although the specific time period is not spelled out in the policy, typically 30 days after receiving a report of the findings, the subrecipient must submit a corrective action plan to the state entity, which details the steps the subrecipient will take to correct the findings. Policy 22 requires state entities to review and approve the corrective action plan.

See Figure 1 on the next page for a flowchart of the subrecipient monitoring process.

**Figure 1**  
**Subrecipient Monitoring Process**



## **CURRENT CONTRACT MANAGEMENT SYSTEM**

Contract management is the continuum of processes used by state entities for administering and reviewing the performance of subrecipient and vendor contracts for efficiency, cost-effectiveness, and service provider accountability and results. To fulfill their responsibilities under Section 12-4-109(d), *Tennessee Code Annotated*, the Department of Finance and Administration promulgated Chapter 0620-3-8 of the *Rules of Department of Finance and Administration* to create a contract management system, which requires each state entity to be responsible for the effective management of its contracts.

### **Annual Contract Management Plan**

The Rule requires state departments and agencies to submit an Annual Contract Management Plan to their chief executive for approval and then to F&A's Office of Contracts Review (OCR) in the Division of Resource Development and Support for posting to the state's intranet. An employee from the state entity's fiscal office typically prepares the Annual Contract Management Plan. These plans are due to OCR by January 1 of each year prior to the state entity submitting any contract for approval in that year.

As specified by the Rule, state entity management must include the following in the Annual Contract Management Plan:

1. information about the specific staff positions and resources that will be assigned to contract management;
2. a description of the organization of identified staff and resources for the contract management responsibility; and
3. an explanation of how the contract management staff will review and supervise contractor performance, progress, and contract compliance.

### **Contract Management Activities**

The Rule states that contract management may include, but is not limited to,

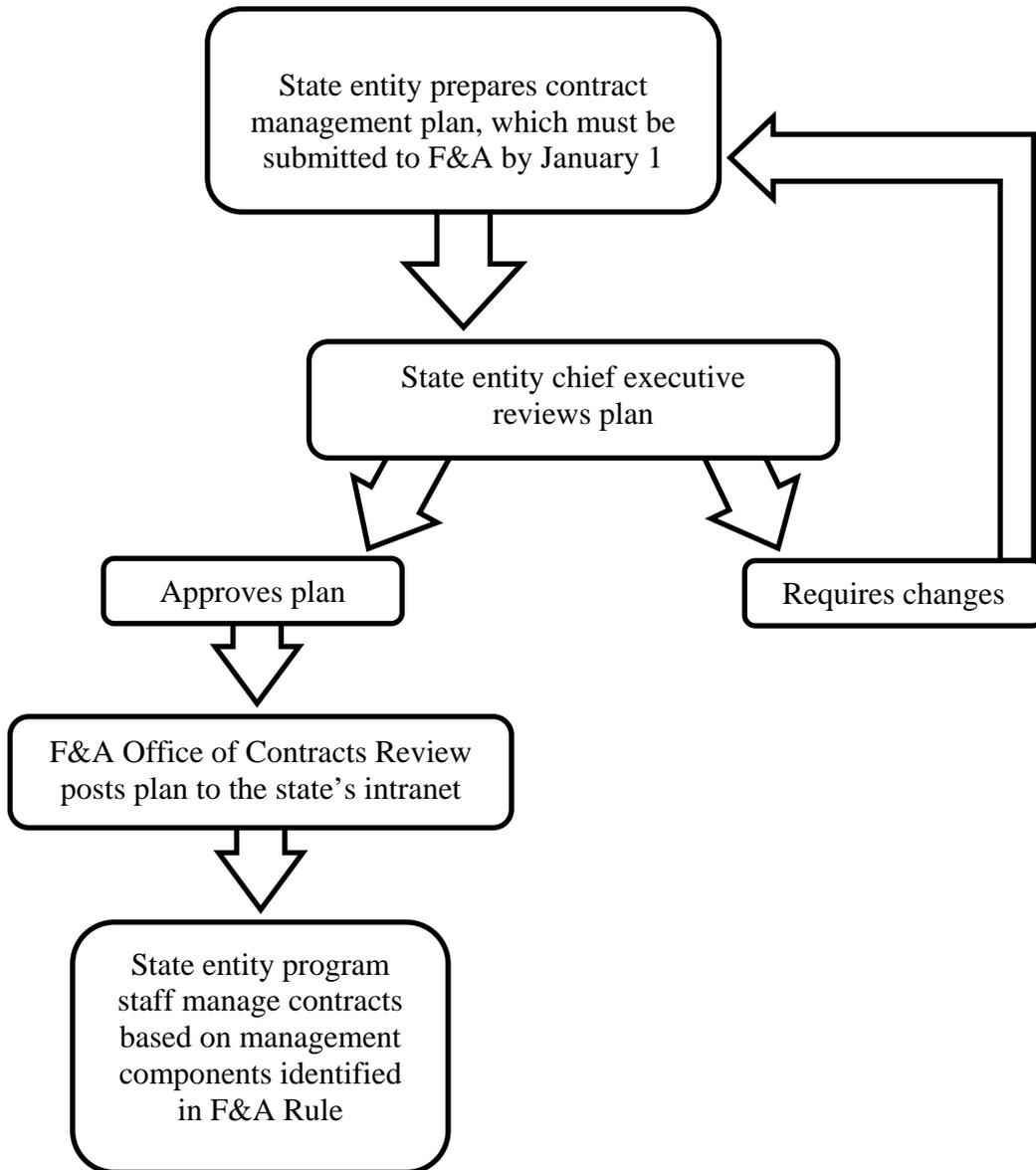
- (a) allocating adequate staff and resources to contract management;
- (b) reviewing contractor performance in terms of progress and compliance with contract provisions;
- (c) communicating with contractors to ensure maximum performance and intended results;
- (d) approving and remitting payments in accordance with contract provisions and applicable law for acceptable work;

- (e) maintaining records of each contract that document activities such as procurement, management, and subrecipient monitoring, if applicable; and
- (f) evaluating contract results in terms of the achievement of organizational objectives.

In most cases, the program staff responsible for procuring the goods or services are also responsible for the actual contract management. Program staff actions to manage the contracts can vary from simply reviewing the submitted invoices for compliance with the contract to conducting site visits to ensure that the entity, and ultimately the state, is receiving the goods and services for which it contracted. See Figure 2 on the next page for a flowchart of the contract management process.

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**Figure 2**  
**Contract Management Process**



The Department of Finance and Administration's Division of Resource Development and Support (RDS) houses the Office of Consulting Services and the Office of Contracts Review, both of which have specific responsibilities in the subrecipient contract monitoring and contract management systems, and other offices not related to subrecipient contract monitoring or contract management. Refer to Appendix 2 on page 20 for an organizational chart of RDS, which was provided to us by a Management Consultant in the Department of Finance and Administration.

### **Office of Consulting Services**

The Office of Consulting Services (OCS), which is under the Director of Audit and Consulting Services, coordinates statewide subrecipient contract monitoring under Policy 22. OCS reviews the subrecipient monitoring plans for each state entity for compliance with Policy 22 requirements, requests revisions to the plans as applicable, and approves the subrecipient monitoring plans. Two Management Consultants, who are directly involved in the subrecipient monitoring process, review the subrecipient monitoring plans and make themselves available to answer any questions that state entity subrecipient liaisons might have.

Additionally, OCS provides training to subrecipient contract liaisons at various state entities. OCS trains these liaisons to prepare subrecipient monitoring plans and monitor subrecipients; the OCS training also covers other applicable topics such as how to monitor subrecipients receiving funds from the American Recovery and Reinvestment Act.

### **Office of Contracts Review**

The Office of Contracts Review (OCR) reviews and approves all state professional services contracts. These contracts can be either subrecipient or vendor contract relationships. By reviewing and approving each professional services contract, OCR serves as a central base of expertise to safeguard the financial and legal interests of the state and to meet the requirements of *Tennessee Code Annotated* and F&A Rules.

Moreover, OCR posts the Annual Contract Management Plans submitted by state entities to the state's intranet. F&A Rules do not require OCR to review or approve the plans. Refer to Appendix 2 on page 20 for an organizational chart of OCR.

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## **AUDIT RESULTS**

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### **SUBRECIPIENT CONTRACT MONITORING**

Based on our interviews, reviews, and testwork, we found that the state relies completely on management at the individual state entities to comply with Policy 22 and does not have an effective oversight mechanism to ensure that state entities are, in fact, complying with Policy 22.

Since 2004, when the state transitioned to a decentralized monitoring system, our office has reported 25 monitoring findings at 12 state entities. See Appendix 3 on page 21 for links to reports containing the findings and a brief summary of each finding. These noted instances of monitoring deficiencies emphasize the need for an oversight mechanism that can independently identify problem areas and implement corrective actions within the contract monitoring process that will enable state officials to provide better assurances to the state's taxpayers that funds used to procure goods and services through contracts are protected from management's ineffectiveness or inefficiency and from error, fraud, waste, and abuse.

Based on our interviews and review of the subrecipient contract monitoring system, we found that there is a misperceived oversight role associated with the Office of Consulting Services (OCS) in the Department of Finance and Administration. We found that although OCS reviews and approves the entities' subrecipient monitoring plans as required by Policy 22, OCS does not perform any of the following basic oversight functions:

- routinely verify that each entity with a subrecipient contract submits a monitoring plan,
- verify the information entities report in the subrecipient monitoring plan,
- routinely determine if state entities follow the submitted monitoring plan, or
- determine if entities verify that subrecipients took corrective action steps to address findings noted in subrecipient monitoring reports.

Our specific issues related to subrecipient contract monitoring are discussed below.

### **Issue 1 - OCS Does Not Routinely Verify That Each State Entity With Subrecipient Contracts Submits a Monitoring Plan**

F&A's Office of Consulting Services (OCS) does not routinely verify whether each state entity that contracts with a subrecipient submits a subrecipient monitoring plan. Under the current monitoring policy, it is the responsibility of each individual state entity to submit a subrecipient monitoring plan when the entity has subrecipient contracts. At the time of our audit, F&A's last documented attempt to verify that applicable state entities had submitted monitoring plans as required was disclosed in a report entitled, "Review of Statewide Compliance with Finance and Administration's Policy 22 – Subrecipient Contract Monitoring," which F&A's Office of Internal Audit issued in January 2008.

In the Scope of Review section, the report stated, ". . . a search was performed using fiscal year 2006 expenditures of agencies that did not submit a Policy 22 monitoring plan, but which appeared to have payments to subrecipients." In the search results, Internal Audit noted two instances of noncompliance.

Furthermore, especially in light of recent American Recovery and Reinvestment Act of 2009 (ARRA) funding the state has received, there may be state entities that have new contract relationships that fall under the auspices of Policy 22. These state entities with subrecipient contracts for the first time may not be aware of the Policy 22 monitoring requirements, and may therefore fail to monitor subrecipient contracts. Additionally, there may be state entities that are aware of the Policy 22 monitoring requirements and still fail to submit a monitoring plan or do not monitor their subrecipient contracts or both.

Because the subrecipient contract monitoring system was designed to be decentralized, OCS is the single control point that can ensure that all state entities with subrecipient contracts submit monitoring plans that lay out a sufficient, effective, and efficient monitoring strategy. Without OCS' proactive oversight, the state is at greater risk for error, fraud, waste, and abuse from subrecipients because the state entities may be monitoring subrecipient contracts ineffectively or inefficiently or not at all. If federal funds are not monitored as required, the state would also be subject to negative/unfavorable actions from the federal government up to and including suspension of federal funding.

## **Issue 2 - OCS Does Not Verify the Information State Entities Report in the Subrecipient Monitoring Plan**

OCS does not independently verify that (1) each state entity submitted a complete listing of its subrecipient contracts, (2) the subrecipient contracts are correctly classified as subrecipient contracts, (3) the risk assessment for each of the contracts is appropriate, and (4) the list of staff responsible for the contracts is complete and accurate.

The value of the subrecipient contract monitoring system as a key control function depends on complete and accurate subrecipient monitoring plans prepared by state entities responsible for oversight of the respective contracts. For example, an entity must monitor a third of the total number of its subrecipient contracts; therefore, if entities do not include a complete listing of the contracts or if the contracts are not correctly classified as either a subrecipient or a vendor, then entities may be monitoring too few subrecipient contracts or not achieving the federal or state monitoring requirements, or both. Additionally, if entity management's risk assessments are not appropriate, entity staff may not be monitoring subrecipient contracts that pose the greatest risk.

Because OCS does not engage in true oversight activities, it does not meet its responsibilities for maintaining an effective and efficient contract monitoring system and does not fully assume true oversight responsibilities for Policy 22 compliance. As a result, the state and taxpayers must rely on state entities to comply with the important objectives of Policy 22 without any central control point.

### **Issue 3 - OCS Does Not Routinely Determine If State Entities Follow the Submitted Monitoring Plan**

OCS does not routinely determine whether the state entities follow their monitoring plans. At the time of our audit, F&A's last documented attempt to determine if state entities followed the submitted monitoring plans was disclosed in a report entitled, "Review of Statewide Compliance with Finance and Administration's Policy 22 - Subrecipient Contract Monitoring," which F&A's Office of Internal Audit issued in January 2008.

In the discussion of their review, Internal Audit staff noted that they selected a sample of entities that submitted a monitoring plan for FY 2006 and reviewed the monitoring work that was performed on a sample of each entity's contracts based on the plan. Based on the results of their monitoring work paper review, Internal Audit staff concluded that state entities did not always issue the required monitoring reports; issue the monitoring reports timely; adequately monitor contracts, including federal and state requirements; and document the review of the subrecipient's compliance with Title VI.

As a result of this gap in oversight, state entities could submit a monitoring plan each year—giving the appearance that the entity is monitoring its subrecipient contracts as stated in the plan—without monitoring the subrecipients and without OCS being aware of this major failure in the control.

### **Issue 4 - OCS Does Not Require State Entities to Verify That Subrecipients Take Corrective Action Steps to Address Monitoring Findings and Thus Does Not Know Whether State Entities Ensure That Subrecipients Take the Necessary Corrective Actions**

Policy 22 does not require state entities to conduct follow-up reviews to ensure that subrecipients have completed the actions identified in corrective action plans. As a consequence, state officials do not have any assurances that subrecipients take the necessary actions to address monitoring findings.

## **CONTRACT MANAGEMENT**

Based on our interviews, reviews, and testwork, we did not identify any specific contract management issues.

## **OVERALL RECOMMENDATION**

We recommend that officials in the Department of Finance and Administration and in the state's newly established Procurement Office (created by Section 4-56-104, *Tennessee Code Annotated*) study the state's contract monitoring and management systems to identify specific actions to address the oversight issues, and by October 1, 2012, report actions to be taken to the

Comptroller of the Treasury, Fiscal Review Committee, and the newly formed State Procurement Commission (created by Section 4-56-102, *Tennessee Code Annotated*). State officials should ensure that changes to the current contract monitoring and management systems ensure that taxpayer funds used to procure goods and services through subrecipient and vendor contracts are used effectively and efficiently and are protected from error, fraud, waste, and abuse. In addition to the state's development of an effective oversight mechanism, the chief executives of each state entity should take direct responsibility for ensuring that their entity's respective subrecipient and vendor contracts are properly monitored and managed.

See Appendix 4 for the official response to this report from the Commissioner of the Department of Finance and Administration.

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## OBSERVATIONS AND COMMENTS

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As part of our review of the subrecipient contract monitoring system, we noted the following items related to Policy 22, which we wanted to bring to management's attention.

### **POLICY 22 MINIMUM-NUMBER MONITORING REQUIREMENT**

When a state entity selects the population of contracts to be monitored in accordance with Policy 22, one of the two main criteria that must be met states,

Affected agencies must annually monitor a **minimum** of 1/3 of the total number of all subrecipient contracts executed by their agency (in addition to those chosen to meet the federal monitoring frequency requirements).

For state entities that have a large number of small-dollar subrecipient contracts, this minimum requirement forces the entities to devote staff resources to monitor the required number of subrecipients rather than allowing monitoring staff to focus their resources on the contracts that pose the greatest risk in terms of dollars spent.

With regard to the required monitoring of one-third of subrecipients, the Department of Finance and Administration may want to reevaluate the relevance of this requirement.

### **POLICY 22 COMPLIANCE REVIEWS**

With regard to compliance reviews, Policy 22 states,

Agency and department activities conducted, and records maintained, pursuant to this policy shall be subject to evaluation by the Department of Finance and

Administration, the Comptroller of the Treasury, or their duly appointed representatives.

However, the *Tennessee Subrecipient Contract Monitoring Manual*, which was developed to help implement Policy 22, states that the Comptroller of the Treasury's Division of State Audit is responsible for ensuring entity compliance with Policy 22.

The Division of State Audit cannot and should not be a part of the internal control system for the subrecipient monitoring system. Such an involvement would compromise the division's independence with respect to the audits of state entities. Moreover, the Division of State Audit conducts audits of entities based on risk rather than scheduled engagements; therefore, F&A's reliance on the Division of State Audit to identify Policy 22 noncompliance is not practical or prudent.

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## APPENDICES

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### APPENDIX 1 - DETAILED SCOPE AND METHODOLOGY

#### PLANNING PROCEDURES

In the planning phase of the audit, we performed the following procedures:

1. Reviewed relevant documents including:
  - *Tennessee Code Annotated*, Section 12-4-109, Contracts for state services;
  - Chapter 0620-3-8 of the *Rules of the Department of Finance and Administration*, “Contract Management and Subrecipient Monitoring”;
  - F&A’s Policy 22, “Subrecipient Contract Monitoring”;
  - the *Tennessee Subrecipient Contract Monitoring Manual*;
  - the report of Department of Finance and Administration’s Office of Internal Audit, dated January 16, 2008, entitled “Review of Statewide Compliance with Finance and Administration’s Policy 22, Subrecipient Contract Monitoring”; and
  - guidelines sent out by F&A entitled “Communication to Agencies concerning Policy 22 Monitoring Plans for FY2009-10,” which addressed American Recovery and Reinvestment Act (ARRA) contracts.
2. Interviewed officials in the Office of Consulting Services and Office of Contracts Review at the Department of Finance and Administration to gain an understanding of how the state’s current subrecipient contract monitoring and contract management systems were designed to operate.
3. Reviewed information available from the Division of State Audit, as deemed necessary, including:
  - relevant prior performance audit reports and working papers;
  - relevant financial and compliance audit reports and working papers; and
  - correspondence files for applicable state entities.

4. Interviewed officials in other southeastern states (Alabama, Arkansas, Florida, Georgia, Kentucky, Mississippi, North Carolina, South Carolina, Virginia, and West Virginia) and California, Illinois, Indiana, New York, and Texas to gain an understanding of the subrecipient monitoring and contract management efforts in those states.

## **DETAILED AUDIT PROCEDURES**

Based on our inquiries and review of contract listings, we determined that all state entities that had subrecipient contracts also had vendor contracts. Therefore, we obtained a schedule of all state entities that submitted Fiscal Year 2009 subrecipient monitoring plans from the Office of Consulting Services. From that schedule, we selected the following sample of state entities that administered both subrecipient contracts and vendor contracts:

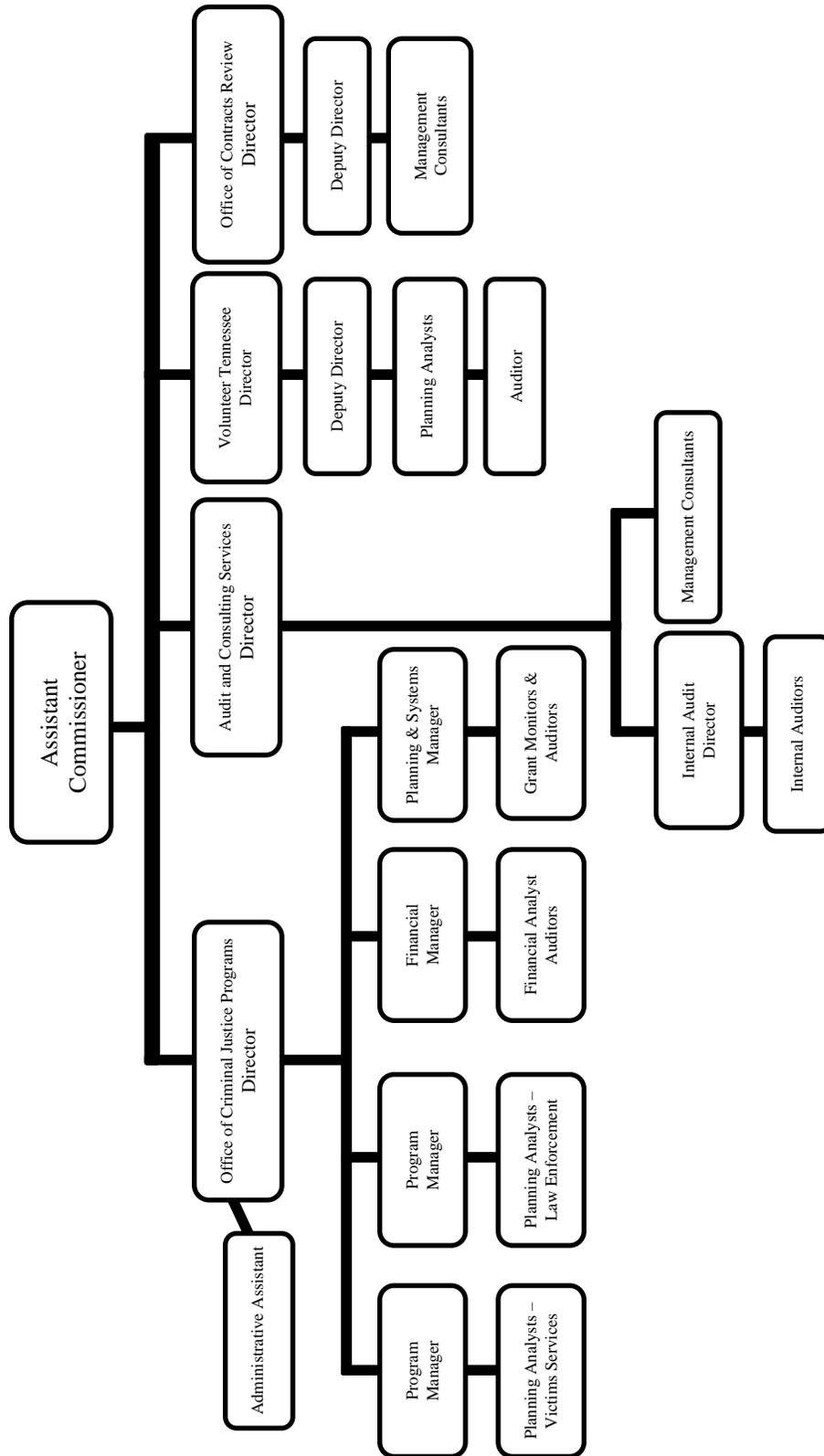
- Commission on Aging and Disability;
- Commission on Children and Youth;
- Department of Agriculture;
- Department of Commerce and Insurance;
- Department of Economic and Community Development;
- Department of Mental Health and Developmental Disabilities;
- Department of Tourist Development; and
- Tennessee Bureau of Investigation.

At each of the eight state entities, we performed the following procedures:

1. Interviewed state entity officials, including subrecipient contract monitoring and contract management staff, to hear their perspective about how the contract monitoring and management process works.
2. Obtained and reviewed the state entity's subrecipient monitoring plan for the fiscal year ended June 30, 2009, (Fiscal Year 2009) to determine if the plan fulfilled the requirements outlined in Policy 22.
3. Selected a sample of subrecipients from the Fiscal Year 2009 population of subrecipients that the entity had selected for monitoring and tested to determine if the state entity monitored the subrecipient contracts in accordance with Policy 22.

4. Obtained and reviewed the state entity's subrecipient monitoring plan for the 2010 fiscal year to determine if the entity addressed F&A's new subrecipient monitoring requirements for contracts funded by the American Recovery and Reinvestment Act of 2009 (ARRA).
5. Obtained and reviewed the state entity's Annual Contract Management Plan to determine if the plan fulfilled the requirements outlined in Chapter 0620-3-8-.04 (2) of the *Rules of the Department of Finance and Administration*.
6. Selected a sample of the state entity's vendor contracts and tested to determine if the entity managed the contracts in accordance with Chapter 0620-3-8-.04 (1) of the *Rules of the Department of Finance and Administration*.

**APPENDIX 2 - DIVISION OF RESOURCE DEVELOPMENT AND SUPPORT  
ORGANIZATIONAL CHART**



### **APPENDIX 3 - LIST OF FINDINGS FROM OTHER AUDITS**

#### **Tennessee Commission on Children and Youth - 2005 - Finding 1 (page 7)**

<http://www.comptroller1.state.tn.us/repository/SA/ag05068.pdf>

The controls over monitoring of the grant contracts awarded by the commission to local governments and other agencies are not adequate. Several subrecipients had not been monitored as required. In addition, the commission did not submit a monitoring plan for 2005 as required by the Department of Finance and Administration's Policy 22, *Subrecipient Contract Monitoring*.

#### **Department of General Services - 2006**

<http://www.comptroller1.state.tn.us/repository/SA/pa05059.pdf>

- Finding 1 (page 8)  
Contract monitoring, which is decentralized and lacks direction, does not adequately ensure that the state receives what it paid for in quality and quantity.
- Finding 8 (page 34)  
The department is not sufficiently monitoring its own activities and federal surplus property donees for compliance with Title VI, which could result in the department being out of compliance with federal regulations and the subsequent loss of federal funds.
- Finding 10 (page 38)  
The Office of Internal Audit is not conducting contract audits as frequently as intended by policy to ensure that vendors are complying with their contract and using state funds appropriately and in a lawful manner.

#### **Tennessee Arts Commission - 2006 - Finding 6 (page 22)**

<http://www.comptroller1.state.tn.us/repository/SA/ag05079.pdf>

The commission did not submit a subrecipient contract monitoring plan by October 1, 2004, as required by Department of Finance and Administration Policy 22. The monitoring plan and the monitoring performed by the commission also did not comply with Policy 22.

#### **Tennessee Commission on Children and Youth - 2006 - Finding 4 (page 27)**

<http://www.comptroller1.state.tn.us/repository/SA/pa05081.pdf>

The commission's monitoring of grantees needs improvement to ensure commission staff (and other stakeholders) have accurate and in-depth information on grantees' activities and the extent to which they met goals and objectives.

#### **Tennessee Emergency Management Agency - 2007 - Finding 4 (page 18)**

<http://www.comptroller1.state.tn.us/repository/SA/pa07024.pdf>

The agency is not properly monitoring subgrantees for program and financial compliance according to state and federal guidelines.

**Department of Safety - 2008 - Finding 11 (page 52)**

<http://www.comptroller1.state.tn.us/repository/SA/pa07076.pdf>

The department is not monitoring its contractors and grantees for Title VI compliance or providing Title VI training and guidance to the Highway Patrol.

**Department of Environment and Conservation - 2010 - Finding 2 (page 15)**

<http://www.comptroller1.state.tn.us/repository/SA/pa09029.pdf>

The department did not monitor the minimum number and dollar amount of its subrecipient contracts as required by the Department of Finance and Administration.

**2004 Single Audit**

<http://www.comptroller1.state.tn.us/repository/SA/sa04119.pdf>

- [Department of Health - Finding 04-TDH-02 \(page 71\)](#)  
The department did not adequately monitor a high risk WIC vendor.
- [Department of Health - Finding 04-TDH-07 \(page 83\)](#)  
The department did not monitor the required percentage of local agencies or clinics for the WIC program.
- [Department of Human Services - Finding 04-DHS-14 \(page 109\)](#)  
The department did not always properly monitor organizations that provided services for the Division of Rehabilitation Services.
- [Department of Human Services - Finding 04-DHS-15 \(page 124\)](#)  
The department has not always properly monitored its contractors in the Temporary Assistance for Needy Families program.
- [Department of Human Services - Finding 04-DHS-16 \(page 183\)](#)  
The department failed to monitor organizations that received over \$16 million to provide services for the Child Care program, and the results of monitoring visits did not always agree with conclusions in the monitoring reports.
- [Department of Labor and Workforce Development - Finding 04-LWD-01 \(page 177\)](#)  
The department did not monitor all of its Workforce Investment Act subrecipient contracts.
- [Military Department of Tennessee - Finding 04-DOM-01 \(page 152\)](#)  
Controls related to federal subrecipient monitoring requirements are insufficient.

- University of Tennessee - Finding 04-UTS-01 (page 154)  
The university failed to ensure that all of its federal research and development subrecipients were properly audited.

### **2005 Single Audit**

<http://www.comptroller1.state.tn.us/repository/SA/sa06066.pdf>

- Department of Health - Finding 05-TDH-04 (page 90)  
The department did not assess and mitigate the risks associated with inadequate policies and procedures governing the follow-up and corrective action of monitoring deficiencies in the Block Grants for Prevention and Treatment of Substance Abuse program.

### **2006 Single Audit**

<http://www.comptroller1.state.tn.us/repository/SA/sa07067.pdf>

- Department of Human Services - Finding 06-DHS-04 (page 54)  
The Department of Human Services did not ensure that a required audit was performed timely and as a result has not mitigated the risk that funds spent by a subrecipient were for unallowable costs.
- Department of Human Services - Finding 06-DHS-05 (page 60)  
The Department of Human Services did not issue a management decision on audit findings and did not ensure that timely corrective actions were made, increasing the risk that program noncompliance by subrecipients could continue for an extended period of time before detection.
- Military Department of Tennessee - Finding 06-DOM-01 (page 78)  
The Military Department of Tennessee developed, but did not implement, procedures for on-site monitoring of subrecipients of Homeland Security grants, thereby increasing the risk of federal funds being used for unauthorized purposes.
- Department of Transportation - Finding 06-DOT-03 (page 88)  
The department did not always comply with OMB Circular A-133 regarding the monitoring of subrecipients, increasing the risk of the department not detecting problems with subrecipients.

### **2007 Single Audit**

<http://www.comptroller1.state.tn.us/repository/SA/sa08025.pdf>

- Department of Transportation - Finding 07-DOT-02 (page 81)  
As stated in the prior audit, the department did not always comply with OMB Circular A-133 regarding the monitoring of subrecipients, increasing the risk of the department not detecting fraud, waste, abuse, and noncompliance problems with subrecipients.

## **2010 Single Audit**

[http://www.comptroller1.state.tn.us/repository/SA/2010\\_TN\\_Single\\_Audit.pdf](http://www.comptroller1.state.tn.us/repository/SA/2010_TN_Single_Audit.pdf)

- Department of Environment and Conservation - Finding 10-TDEC-01 (page 74)  
Because management and staff of the Department of Environment and Conservation did not adequately familiarize themselves with OMB Circular A-133, Section 400(d), which defines the responsibilities of pass-through entities who pass federal grant funds to subrecipients, the department and subrecipients who received and spend federal funds did not comply with these requirements, resulting in federal questioned costs of \$10,506,832.
- Department of Transportation - Finding 10-DOT-08 (page 37)  
In some instances, the department did not comply with the Department of Finance and Administration's subrecipient monitoring requirements, thereby increasing the risk of not detecting fraud, waste, abuse, and noncompliance by subrecipients.

**APPENDIX 4 - OFFICIAL RESPONSE FROM THE DEPARTMENT OF FINANCE AND  
ADMINISTRATION**



STATE OF TENNESSEE  
DEPARTMENT OF FINANCE AND ADMINISTRATION  
STATE CAPITOL  
NASHVILLE, TENNESSEE 37243-0285

RECEIVED  
SEP - 7 2011  
STATE AUDIT

Mark A. Emkes  
Commissioner

September 8, 2011

Arthur A. Hayes, Director  
Comptroller of the Treasury  
James K. Polk Building, 15<sup>th</sup> Floor  
Nashville, TN 37243

Dear Mr. Hayes,

We have reviewed your office's performance audit of Tennessee's Contract Monitoring and Management Systems. Attached please find our department's response to the issues discussed.

If you have any questions concerning these responses, please call Buddy Lea, Assistant Commissioner.

Sincerely,

A handwritten signature in cursive script that reads "Mark A. Emkes".

Mark A. Emkes  
Commissioner

MAE/REL/rhm

Attachments

cc: Shirley Henry, Manager  
Comptroller of the Treasury

**Response to Comptroller of the Treasury's  
Review of Tennessee's Contract Monitoring and Management Systems  
Draft Report Dated 8-25-2011 / Due 9-8-2011**

In response to the overall recommendation noted in this report, the department provides the following response:

In early 2004, F&A management chose to shift from a centralized grant monitoring office to a decentralized subrecipient monitoring approach thereby creating an environment in which agencies and departments with subrecipient relationships became responsible for ensuring their subrecipient contracts are adequately monitored. A collaborative effort was undertaken with staff from the Comptroller's Office seeking their input and guidance to accomplish revising Policy 22.

Although this shift placed the responsibility of carrying out the monitoring function into the hands of the various agencies, the objective of the revised policy was to establish a State-wide uniform subrecipient monitoring approach. As noted in this report, chief executives of each State agency and department are responsible for ensuring their respective entity's subrecipients are properly managed and monitored. The revised policy was not intended to prescribe F&A with the responsibility for maintaining a contract monitoring system assuming oversight responsibilities for State entities' compliance with Policy 22.

Since the revised policy provides a State-wide uniform monitoring approach, but does not prescribe F&A provide an oversight role, management believes the department exercised due diligence in carrying out its role as defined by the revised policy. Recognizing the importance of monitoring activities to efficiently and effectively manage taxpayer funds, the department undertook a number of additional efforts to help ensure applicable State entities comply with Policy 22.

F&A recognizes the value of the recommendations expressed by the Comptroller's staff concerning oversight functions of monitoring activities to efficiently and effectively manage taxpayer funds. The department will work collaboratively with the newly established Procurement Office (and consult with staff from the Comptroller's office as was done in 2004) to study the State's contract monitoring and management systems to identify possible actions and the additional costs involved to address the issues and observations raised in this report.

In response to the specific issues noted in this report, the department provides the following responses:

**1. OCS Does Not Routinely Verify That Each State Entity With Subrecipient Contracts Submits a Monitoring Plan**

This statement is valid. However, there is no requirement or statement in F&A Policy 22 requiring OCS or any other centralized agency to perform this function other than the State entities themselves.

As stated under the current policy, it is the responsibility of each individual State entity to submit a subrecipient monitoring plan. Although not required per policy, OCS has taken the following routine actions to help ensure applicable State entities submit an annual monitoring plan:

- notifying agency points of contact on an annual basis reminding them of the requirements of F&A Policy 22, and
- providing annual informational sessions for all interested entities to attend.

In addition to further create awareness to those State entities who may or may not be aware of Policy 22 and its requirements, the department has taken the following actions:

- coordinating with staff in the Division of Accounts to notify agency fiscal officers, and
- analyzing prior year expenditure data to identify possible State entities with subrecipient contracts for which a subrecipient monitoring plan was required.

Also in light of the American Recovery and Reinvestment Act of 2009 (ARRA), OCS coordinated with the TRAM office to develop guidelines and provide training to State agencies to help ensure ARRA grants were included and monitored in their annual monitoring plans.

**2. OCS Does Not Verify the Information State Entities Report in the Subrecipient Monitoring Plans**

This statement is valid. However, there is currently no requirement or statement in F&A Policy 22 requiring OCS or any other centralized agency to perform this function other than the State entities themselves.

Given the inherent challenges to independently verify the completeness of a State entity's population of subrecipient contracts, the contract designation as subrecipient, the assigned risk of each State contract, and the list of responsible monitoring staff, OCS verifies each State entity's monitoring plan submitted meets the required information as defined per policy.

The revised policy was not intended to nor did it prescribe F&A with the responsibility for maintaining a contract monitoring system assuming oversight responsibilities for State entities' compliance with Policy 22.

**3. OCS Does Not Routinely Determine If State Entities Follow the Submitted Monitoring Plan**

This statement is valid. However, there is currently no requirement or statement in F&A Policy 22 requiring OCS or any other centralized agency to perform this function other than the State entities themselves.

Although not required per policy, OCS has taken efforts to assess State entities' compliance efforts with submitted and approved monitoring plans. This was undertaken to advise both F&A management and management of the applicable State entities of their entity's monitoring efforts as per their approved plan.

**4. OCS Does Not Require State Entities to Verify That Subrecipients Take Corrective Action Steps to Address Monitoring Findings and Thus Does Not Know Whether State Entities Ensure That Subrecipients Take the Necessary Corrective Actions**

This statement is valid. However, there is currently no requirement or statement in F&A Policy 22 requiring OCS or any other centralized agency to perform this function other than the State entities themselves.

Each State entity is responsible for ensuring their respective subrecipient's corrective action plan is implemented to address monitoring findings identified. Given the yearly nature of most subrecipient grant contracts and timing of the monitoring reviews performed predominately during the latter half of the monitoring year, State entities' monitoring resources may be significantly challenged to conduct follow-up reviews to ensure subrecipients have completed the corrective actions identified.

However, more often the case, programmatic staff of State entities is tasked with the programmatic responsibility to manage their subrecipients to ensure compliance with an approved corrective action plan. In addition, annually State entities defined the risk criteria used to assess and assign the risk of a subrecipient in developing their annual monitoring plan. The grant award process and risk criteria used by most State entities incorporate subrecipients' prior monitoring findings and corrective actions into their assessments. These actions by State entities help ensure subrecipients take necessary actions to address monitoring findings.