An Audit Report on

Fees at the Department of Agriculture

August 2017

Report No. 17-049

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Overall Conclusion

The Department of Agriculture (Department) set its fees at levels that exceeded the amounts necessary to recover its direct and indirect costs. From January 1, 2016, through December 31, 2016, for its agriculture and consumer protection cost-recovery programs, the Department's revenues ($27.3 million) exceeded its expenditures ($20.8 million) by 31 percent ($6.5 million).

In addition, the Department did not have formal processes for monitoring its expenditures for its cost-recovery programs to determine whether its fees were set appropriately to recover costs. As of March 17, 2017, the Department had not compared its actual revenues and expenditures to evaluate whether it set its fees appropriately. It is important that the Department has processes in place for monitoring fee levels for its cost-recovery programs so that it can evaluate and update its fee structure when its actual direct and indirect costs change.

> **Background Information**
>
> Texas Agriculture Code, Section 12.0144, requires the Department to set fees in an amount that offsets, when feasible, the direct and indirect costs of administering its regulatory activities.
>
> The General Appropriations Act (GAA) specifies the Department's cost-recovery programs. For the 2016-2017 state fiscal biennium, the GAA grouped the Department's cost-recovery programs within nine strategies.
>
> In September 2015, the Department completed a cost-recovery rate analysis to estimate costs for its agriculture and consumer protection cost-recovery programs. Those programs are designed to ensure the quality and quantity of various consumer products and services, provide value-added certification of agricultural products, and enforce statutory requirements.
>
> As a result of that analysis, the Department proposed a number of changes to its fee schedule.
>
> Sources: The Texas Agriculture Code, the GAA (84th Legislature), and the Department.

The Department's fee schedule, which went into effect on January 1, 2016, was based on a cost-recovery rate analysis (rate analysis) that the Department completed for its agriculture and consumer protection cost-recovery programs in September 2015 (see text box for more information about those programs). That rate analysis included estimates organized into three cost categories: (1) operating costs, (2) indirect costs, and (3) direct labor costs.

As part of its rate analysis, the Department included a $4.6 million contingency estimate that was not based on specific actual expenditures or projected costs; therefore, it was not a direct or indirect cost that the Department was required to recover. That contingency estimate represented 17 percent of its total estimated costs.

The Department consistently applied its methodology for estimating direct labor costs and those estimates were based on supported amounts. However, the Department did not clearly define and document its methodology for estimating its operating and indirect costs. It also did not consistently maintain support for its estimates of operating and indirect costs, and auditors identified errors in some of

This audit was conducted in accordance with Texas Government Code, Sections 321.0131 and 321.0132.

For more information regarding this report, please contact Audrey O'Neill, Audit Manager, or Lisa Collier, First Assistant State Auditor, at (512) 936-9500.

the Department's estimates. As a result, the Department may not be able to evaluate its methodology or replicate its cost estimation and fee-setting processes going forward, and auditors were not able to assess the reasonableness of certain operating and indirect cost estimates.

After the Department estimated total costs for each strategy, it reviewed its fee structure and adjusted its fees as it determined necessary to recover those estimated costs. However, it did not maintain documentation of its methodology for determining the amounts at which it should set individual fees within each strategy to recover estimated costs.

Auditors communicated other, less significant issues to Department management separately in writing.

Table 1 presents a summary of the findings in this report and the related issue ratings. (See Appendix 2 for more information about the issue rating classifications and descriptions.)

Table 1

Summary of Chapters/Subchapters and Related Issue Ratings		
Chapter/ Subchapter	Title	Issue Rating [a]
1	The Department's Revenues Exceeded Its Expenditures, and the Department Should Establish Processes for Monitoring Fee Levels for Its Cost-recovery Programs	Priority
2-A	The Department Did Not Clearly Define Its Methodology or Maintain Documentation for Estimating Costs	High
2-B	The Department Did Not Adequately Document Its Methodology for Setting Individual Fees in Each Strategy to Recover Estimated Costs	Medium

[a] A chapter or subchapter is rated Priority if the issues identified present risks or effects that if not addressed could critically affect the audited entity's ability to effectively administer the program(s)/function(s) audited. Immediate action is required to address the noted concern and reduce risks to the audited entity.

A chapter or subchapter is rated High if the issues identified present risks or effects that if not addressed could substantially affect the audited entity's ability to effectively administer the program(s)/function(s) audited. Prompt action is essential to address the noted concern and reduce risks to the audited entity.

A chapter or subchapter is rated Medium if the issues identified present risks or effects that if not addressed could moderately affect the audited entity's ability to effectively administer program(s)/function(s) audited. Action is needed to address the noted concern and reduce risks to a more desirable level.

A chapter or subchapter is rated Low if the audit identified strengths that support the audited entity's ability to administer the program(s)/functions(s) audited or the issues identified do not present significant risks or effects that would negatively affect the audited entity's ability to effectively administer the program(s)/function(s) audited.

Summary of Management's Response

At the end of each chapter in this report, auditors made recommendations to address the issues identified during this audit. The Department generally agreed with the recommendations in this report; however, it did not fully agree with certain findings in Chapters 1 and 2-A. The Department's detailed management responses are presented immediately following the recommendations at the end of each chapter in this report. The Department's overall management response is presented in Appendix 3.

After review and consideration of management's responses, the State Auditor's Office stands by its conclusions based on the evidence presented and compiled during this audit.

Audit Objectives and Scope

The objectives of this audit were to:

- Assess the Department's process for setting fees.
- Determine whether the Department has set selected fees in amounts that offset the costs of administering the associated regulatory activities.

The scope of this audit covered the Department's cost-recovery strategies as defined in the General Appropriations Act (84th Legislature), with a focus on the seven cost-recovery strategies included in the Department's September 2015 *Cost Recovery Rate Analysis*.

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Detailed Results

Chapter 1

The Department's *Revenues Exceeded Its Expenditures, and the Department Should Establish Processes for Monitoring Fee Levels for Its Cost-recovery Programs*

Chapter 1 Rating:

Priority [1]

The Department of Agriculture's (Department) actual revenues exceeded its actual expenditures for 2016, and the Department did not have processes in place for monitoring its fee levels to ensure that they were set appropriately.

The Department set its fees at levels that were higher than necessary to recover its costs.

The Department set its fees for its agriculture and consumer protection cost-recovery programs at levels that exceeded the amounts necessary to recover direct and indirect costs. Texas Agriculture Code, Section 12.0144, requires the Department to set its fees to recover direct and indirect costs, when feasible.

According to a comparison the Department performed at the request of the State Auditor's Office, for January 1, 2016, through December 31, 2016, the Department's $27,291,919 in revenues exceeded its $20,799,685 in expenditures for its agriculture and consumer protection cost-recovery programs by $6,492,234 (31 percent).

The Department did not have processes in place for monitoring its cost-recovery program expenditures and its fee levels.

While the Department monitored revenues for its cost-recovery programs to complete required quarterly revenue reports[2], the Department did not have formal processes in place for monitoring expenditures for its cost-recovery programs. As of March 17, 2017, the Department had not compared its actual revenues to its actual expenditures for its cost-recovery programs and, as a result, it did not evaluate whether it set the fees that went into effect on January 1, 2016, appropriately to recover costs.[3]

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[1] Chapter 1 is rated Priority because the issues identified present risks or effects that if not addressed could critically affect the audited entity's ability to effectively administer the program(s)/function(s) audited. Immediate action is required to address the noted concern and reduce risks to the audited entity.

[2] Rider 28, page VI-9, the General Appropriations Act (84th Legislature), required the Department to report its fee-generated revenues for each cost-recovery program to the Office of the Comptroller of Public Accounts and the Legislative Budget Board for the second, third, and fourth quarters of each fiscal year.

[3] At the request of the State Auditor's Office, the Department completed a comparison of actual revenues and expenditures for its cost-recovery programs in April 2017.

It is important that the Department has processes in place for monitoring fee levels for its cost-recovery programs because the factors it considered when developing its cost estimates may change. For example, the Department's estimates included $232,500 associated with a contract that the Department canceled after its fee schedule went into effect. In addition, other costs the Department considered in its estimates, such as costs that the General Appropriations Act requires it to recover, may change between biennia. Without regular monitoring, the Department cannot evaluate and, if necessary, update its fee structure on a timely and regular basis when its actual direct and indirect costs change.

Recommendations

The Department should:

- Develop and implement processes to monitor expenditures for its cost-recovery programs, and periodically compare those expenditures with its revenues for those programs.
- Evaluate whether it should update its fee structure based on its comparison of actual revenues and actual expenditures to ensure that it sets fees at amounts necessary to recover its costs.

Management's Response

The Department generally agrees with the recommendations.

The new rates went into effect January 1, 2016, and, as expected, revenues exceeded expenditures because the rates included a working capital (cash flow) safety net ($2.6M) and funding for uncontrollable costs ($2M) that may occur and have occurred in the past. In addition, as part of the Department's goal to develop more cost effective programs, efficiencies have occurred in the cost recovery programs that have resulted in additional revenue collections (expansion in inspections) plus a reduction in costs for a net savings of approx. $0.8M. These items combined account for $5.4M of the $6.5M variance stated in the SAO report.

The Department will monitor the individual cost programs over a period of time that is sufficient to develop trend analyses. Depending on the cost recovery program, the Department may have to obtain 3 to 5 years of revenue collections and expenditures for a meaningful trend analysis to determine if changes need to be made.

<u>Monitoring programs</u>

As part of the periodic cost recovery financial reporting to the Legislative Budget Board (LBB) and Comptroller's Office ("CPA"), the Department has been monitoring the revenue collections for each of the cost recovery programs as the revenue collected must not only cover the costs of the program, but also the "Other Direct and Indirect Costs" ("ODIC") that is assessed by the Legislative Budget Board ("LBB"). This periodic review includes a review of costs at the strategy level to determine if the revenue collections by program are sufficient to cover all incurred and projected costs. At a more detailed level, the Department's budget staff also verify appropriations are available in the statewide accounting system ("USAS") as part of their review of requisitions which is performed on a daily basis. As clarification, the ODIC surcharge is not part of the Department's appropriations, but based on the GAA 2016-17 revenue collection requirements, the ODIC surcharge required the Department to collect an additional 29% in revenue over its appropriations.

In addition to the review process stated above, the Department has developed and implemented a budgeting tool that will provide the Department the ability to perform a more comprehensive review of actual expenditures for its cost recovery programs. This project was in progress prior to the beginning of the audit, but was not implemented until after the audit was in progress. The reports developed were provided to the auditors during the audit to assist them in their review of revenue and expenditures by month.

<u>Factors contributing to the available balance</u>

Several factors contributed to the available balance. The Department strives to identify efficiencies throughout all of its programs with the goal of developing more cost effective programs. Some of the efficiencies that have occurred in the cost recovery programs resulting in cost savings of approx. $777,500 include:

- *The elimination of an outsourced function that could be more efficiently and effectively performed in house. The in-house scheduling of inspections and the cancellation of this contract along with the decision to not go forward with the fleet management pilot program will save on an annual basis approx. $232,500.*

- *The cost study assumed a fuel rate of $3.09/gallon which was based on the average fuel costs over the FY12-FY15 period for a total expected cost of $633,464. Due to lower fuel prices in 2016, and better scheduling of* *inspections that resulted in more efficient use of our fleet, the Department experienced a reduction in fuels costs of approx. $305,000.*

- *The Department initiated the "operation maverick" project which focused on finding locations with unlicensed scales. This initiative identified over 6,800 unregistered devices resulting in additional revenue collections of approx. $240,000 for the Weights & Measure program on an annual basis.*

Other factors that contributed to the available balance

- *<u>Limitation of budgeting tools that were available to prior administrations</u>*

  Effective with the GAA 2016-17, the Department no longer has UB authority and no transfer authority for the cost recovery programs. In November 2015, prior to the new fee structures being implemented, the Department submitted to LBB a formal request for UB authority and transfer authority. Article IX of the GAA allows an agency to request such authority; however the Department to this date has not received a response from the LBB.

  By not allowing the Department transfer authority that all other state agencies are allowed, the Legislature has placed the Department in an untenable position. The Department requested UB authority and transfer authority again in the current 85th Legislative Session, but the Legislature did not approve.

- *<u>Appropriations for new fee structure not allowed timely</u>*

  The new fee structures went into effect on January 2016, but the Department's appropriations were not increased until August 25, 2016 (3 business days before the end of the fiscal year). Because the Department cannot obligate funds until appropriations are available, the Department was not able to address operational issues at hand and procure goods and services included in the cost study. This delay by LBB in allowing the Department to increase its appropriations timely and denial of UB authority resulted in $3.8M of fee revenue being deposited in the treasury for general government use. LBB's non-responsiveness of the Department's request for capital budget authority to purchase two weight trucks in 2016 also contributed to the $3.8M ending balance as of 8/31/16.

  The Department faces a similar situation in FY 17. Effective June 28, 2017, the Department received approval from LBB and CPA for a limited increase in its appropriations. The Department must submit a request on a bi-weekly basis to the LBB and CPA for additional increases in *appropriation based on revenue collected. If approval is not granted for all collected revenues, then more funds will end up in the State's general revenue fund.*

- *Appropriation reductions*

In FY16, two of the seven cost recovery programs' appropriations were reduced due to insufficient projected revenue collections. At the beginning of FY17, the Department's appropriations for those two cost recovery programs were subsequently reduced. These reductions in appropriations resulted in the Department having to restrict spending on essential operations until the revenue collections exceeded the reduced appropriations level.

Expected Implementation Dates

- *Implementation of detailed expenditure reports: reports provided to SAO auditors in April 2017; will continue to refine reports as necessary*

- *Evaluation of fee structures and monitoring of expenditures and revenue: on an ongoing basis; development of a formalized process to evaluate fee structures by 12/31/18*

Responsible Management Staff

- *Implementation of reports: Administrator, Budget and Financial Reporting*

- *Evaluation of fee structures and monitoring of expenditures and revenue: Administrator, Agriculture and Consumer Protection; Director, Field Operations; Director, Licensing and Data Quality; Administrator, Budget and Financial Reporting; Administrator, Grants, Revenue, and Accounting*

Chapter 2

The Department Did Not Clearly Define Its Methodology or Maintain Documentation for Estimating Its Costs or Setting Fees as Part of Its Rate Analysis

Rate Analysis and Fee Amounts

The Department's rate analysis report included the current and proposed fee amounts for 171 fees associated with the Department's agriculture and consumer protection cost-recovery programs. The proposed fee amounts included:

- Increases to 110 fees ranging from $0.03 to $300.00, with percent increases ranging from 3 percent to 594 percent.
- The elimination of 3 fees.

The Department did not propose any changes to the other 58 fees in the rate analysis. Of the 58 fees for which the Department did not propose changes, 22 were related to the Department's organics program in its integrated pest management strategy. The Department adopted a revised fee schedule for that program on January 1, 2015.

Source: The Department.

The Department's fee schedule, which went into effect on January 1, 2016, was based on a cost-recovery rate analysis[4] (rate analysis) that the Department completed for its agriculture and consumer protection cost-recovery programs in September 2015 (see text box for more information about the Department's rate analysis and fee amounts). For that rate analysis, the Department (1) estimated its total costs for administering its agriculture and consumer protection cost-recovery programs and then (2) proposed a revised fee structure to recover those estimated costs.

However, the Department did not clearly define its methodology for estimating its costs or setting fees as part of that rate analysis, and it did not consistently maintain support for how it estimated costs and set fees. In addition, some of the Department's estimates did not represent actual or projected annual costs. As a result, the Department may not be able to evaluate its methodology or replicate its cost estimation and fee-setting processes going forward.

[4] See *Cost Recovery Rate Analysis*, September 2015, Department of Agriculture at www.texasagriculture.gov.

Chapter 2-A

The Department Did Not Clearly Define Its Methodology or Maintain Documentation for Estimating Costs

Chapter 2-A
Rating:
High [5]

The Department's total estimated annual costs for administering the agriculture and consumer protection cost-recovery programs within 7 of its 9 cost-recovery strategies[6] was $27,511,985 (see text box for a list of the cost-recovery strategies). The Department's rate analysis report organized its cost estimates into three categories:

The Department's Cost-recovery Strategies

The General Appropriations Act (84th Legislature) for the 2016-2017 biennium grouped the Department's cost-recovery programs within the following strategies:

1. Economic development.
2. Regulate pesticide use.
3. Integrated pest management.
4. Certify produce.
5. Agricultural production development.
6. Verify seed quality.
7. Agricultural commodity regulation.
8. Structural pest control.
9. Inspect measuring devices.

Source: The General Appropriations Act (84th Legislature).

- Operating costs ($8,569,365, or 31 percent).
- Indirect costs ($3,578,829, or 13 percent).
- Direct labor costs ($15,363,791, or 56 percent).

Auditors reviewed the Department's estimates for each of those categories. Although the Department consistently applied its methodology for estimating direct labor costs and those estimates were based on supported amounts, the Department did not clearly define and document its methodology for estimating its operating and indirect costs. It also did not consistently maintain support for its estimates of operating and indirect costs, and auditors identified errors in some of the Department's estimates. Specifically, the Department was unable to provide adequate support for (1) information it used to develop certain cost estimates and (2) assumptions it made when developing those estimates. For some types of operating costs, the Department provided expenditure data that it asserted may have been used to develop its estimates; however, auditors were not able to tie that information to its estimates or determine if that information was actually used to develop those estimates. As a result, auditors were not able to assess the reasonableness of certain operating and indirect cost estimates.

Operating Costs

For its operating costs, the Department included a contingency estimate, and it also did not consistently maintain support for its other estimated operating costs.

[5] Chapter 2-A is rated High because the issues identified present risks or effects that if not addressed could substantially affect the audited entity's ability to effectively administer the program(s)/function(s) audited. Prompt action is essential to address the noted concern and reduce risks to the audited entity.

[6] The Department did not include its economic development cost-recovery strategy or its certify produce cost-recovery strategy in its rate analysis; as a result, those two strategies were not a focus of this audit.

The Department included a $4,600,773 contingency estimate that was not based on actual direct or indirect costs. That estimate represented 54 percent of its total estimated operating costs and 17 percent of its total estimated costs. The Department asserted that the contingency was needed to (1) compensate for anticipated increases in its future costs and potential unanticipated expenses and (2) manage its cash flow. However, the Department did not base that contingency estimate on specific actual expenditures or projected costs; therefore, it was not a direct or indirect cost that Texas Agriculture Code, Section 12.0144, requires the Department to recover.

Instead, after estimating its actual costs, the Department determined that it would need an additional 8 to 21 percent of its total estimated costs (including operating, indirect, and direct labor costs) for each cost-recovery strategy. After performing those calculations, the Department added the resulting total of $4,600,773 to its operating costs estimates for all the strategies included in its rate analysis.

That contingency contributed to the difference between the Department's actual revenues and expenditures for 2016 discussed in Chapter 1.

The Department did not consistently maintain adequate support for its other estimated operating costs, **and auditors identified errors in some of the Department's estimates.** Specifically:

- For 11 of 15 other types of operating cost estimates reviewed by auditors, the Department was unable to provide adequate support for certain components of its estimates. Specifically, it was unable to provide information such as (1) the quantity and unit prices it used to estimate costs, (2) how it estimated total costs, or (3) how it allocated costs to each strategy (see text box for a list of the 15 types of operating costs). For example, the Department asserted that it estimated a total of $870,459 in annual fuel costs; however, it was unable to provide detailed support for that estimate. In addition, it was unable to provide support to show how it determined $633,600 (73 percent) of that total cost should be allocated to the cost-recovery portion of the strategies included in its rate analysis.

Type of Operating Costs

In addition to the contingency estimate discussed earlier in this chapter, which was entitled "60-days working capital/cost relief factor," the Department considered the following 12 types of operating costs for all 7 strategies included in its rate analysis:

- Base budget operating costs.
- Utilities.
- Telecommunication.
- Fuel.
- Uniforms for inspectors.
- Rent - office space.
- Fleet management system.
- Mobi Logistics software licenses.
- Vehicle maintenance and repair.
- Vehicle replacement plan.
- Computer replacement plan.
- Printer replacement plan.

The Department also considered the following three types of operating costs for its inspect measuring devices strategy:

- Replacement schedule for 5-gallon test provers and weights.
- Metrology lab loan repayment.
- Weight truck replacement.

Source: The Department's rate analysis.

For some of those types of operating costs, the Department provided expenditure data to demonstrate that its estimates were similar to its actual costs. For example, for its $120,900 utilities estimate, the Department provided invoices showing that its actual utilities costs for fiscal year 2015 were $128,423. However, auditors were not able to tie that information to the Department's estimates or determine if that information was actually used to develop those estimates.

- The Department provided sufficient support, such as appropriations, pricing information it obtained from vendors, and an existing contract, for the remaining four types of operating cost estimates.

- Auditors identified errors in some of the Department's estimates of operating costs. For example:

  - For its regulate pesticide use strategy, the Department incorrectly included the total cost of $300,000 for specialized equipment it intended to purchase over several years, instead of only the amount it would pay for that equipment annually. As a result, it overestimated its annual costs for that item by at least $254,256.

  - For its inspect measuring devices strategy, the Department estimated that 900 exams would be taken per year when it estimated $50,000 in costs associated with administering its registered technician exam, but it estimated that 550 exams would be taken per year when it estimated the $33,000 in revenues it would collect for that examination fee. According to information that the Department provided auditors, it administered 556 registered technician exams during fiscal year 2016.

Indirect Costs

The Department did not consistently maintain adequate support for its indirect cost estimates, **and auditors identified errors in some of the Department's calculations.** Specifically:

- The Department was unable to provide adequate support for the costs within its total estimated indirect costs. Its total estimated indirect costs included many of the same types of costs that the Department included in its estimates of direct labor costs and operating costs, such as salaries, fuel, and telephones. However, because the Department was unable to provide detail for the types of costs it included in its estimates, auditors were unable to determine whether the $3,578,829 it allocated to its agriculture and consumer protection cost-recovery programs included only indirect costs.

- The number of full-time equivalent (FTE) employees the Department used to allocate a portion of its total estimated indirect costs to each strategy was 30 FTEs higher than the number of FTEs it used in its direct labor costs estimates. For example, auditors calculated that the Department overestimated indirect costs for its regulate pesticide use strategy by $433,720 because it included 20 full-time equivalent (FTE) employees who were not associated with its cost-recovery programs in the calculation it used to allocate a portion of its total indirect costs to that strategy.

In addition, the Department did not prepare an indirect cost-recovery plan that could have helped it more accurately identify and allocate indirect costs as part of its rate analysis. Under Texas Government Code, Chapter 2106, the Department is required to prepare an indirect cost-recovery plan annually and implement the plan by setting fees at amounts sufficient to recover indirect costs.[7]

Direct Labor Costs

The Department consistently applied its methodology for estimating direct labor costs across all cost-recovery strategies in its rate analysis, and those estimates were based on supported amounts. Specifically:

- For each strategy, the Department estimated salaries and longevity pay for its employees and allocated portions of those costs to its cost-recovery programs. Auditors compared the Department's salary and longevity cost estimates for its inspect measuring devices strategy to actual payroll information from the Uniform Statewide Payroll/Personnel System and determined that those cost estimates were supported by the information in that system.

- For each strategy, the Department estimated the "other direct and indirect costs"[8] associated with its employees and used that information to allocate its total appropriation for "other direct and indirect costs" across its cost-recovery programs. The Department is required to recover those costs, for which funds are appropriated in the General Appropriations Act.

[7] In addition, Texas Agriculture Code, Section 12.0144, requires the Department to set fees in an amount that offsets, when feasible, the direct and indirect state costs of administering its regulatory activities.

[8] "Other direct and indirect costs" are specified in the General Appropriation Act and are based on employee benefit contributions, statewide fixed costs, and any applicable revenue bond costs. Those costs are different from agency-specific indirect costs.

Recommendations

The Department should:

- Develop and implement clearly defined and consistent processes for estimating costs for its cost-recovery programs. Those processes should ensure that the Department:
  - Bases its annual cost estimates on actual or projected direct or indirect costs for its cost-recovery programs.
  - Verifies the accuracy of its cost estimates.
  - Consistently applies the methodologies it uses to estimate its costs.
- Maintain supporting documentation showing how it estimates its operating and indirect costs.
- Prepare an indirect cost-recovery plan annually, as required by Texas Government Code, Section 2106.003, and implement that plan by incorporating it into its fee-setting process to ensure that it sets fees at amounts sufficient to recover indirect costs, when feasible.

Management's Response

The Department generally agrees with the recommendations.

There have been staffing changes in the Department of which some of the key staff who worked on the cost studies are no longer with the Department. These key staff, with in excess of 15+ years of experience each in the Department, performed and/or managed the preparation of the detailed operating analysis. This loss of institutional knowledge impacted the Department's ability to respond in more detail to some of the auditors' questions as it relates to the previous staff's assumptions and working papers they developed and/or used.

***Operating costs**: Although all original working papers could not be located to support the operating costs, the auditors were provided actual invoices, records, various communications by staff of the assumptions used, the revenue/expenditure workbooks used to collect the results, and supporting documentation to support actual costs and projections during the timeframe that the cost studies were being conducted. The Department believes the documentation provided to the auditors provided a reasonable approximation of the operating costs used in the study.*

<u>60 day working capital and cost relief factors</u>: Budget restrictions on the movement of funds within the Department and across appropriation years required the Department to build a 60 day working capital and cost relief factors into each program study to ensure cost recovery requirements can be met and adequate funds are available for administering programs each year.

The 84th Legislature appropriated funds for the agency with the intent that the Department should fully recover all program costs designated as cost recovery with little reliance on general revenue. This new mandate removed the taxpayer support of general revenue and in effect superseded the Texas Agriculture Code Section 12.0144 which requires the Department to set fees in an amount which offsets, when feasible, the direct and indirect costs of administering its regulatory activities.

This change by the Legislature resulted in a greatly increased risk of lack of operating funds available to the Department within any particular strategy if annual projections of available funds or estimates of expenses are incorrect on the low side. For example, the Department's revenue collections can be seasonal in nature and can vary significantly from month to month depending upon license renewal dates. Unanticipated costs occur and funding must be available for such occurrences as technology infrastructure repairs, unanticipated disasters, equipment breakdowns, overtime, on-going annual increase for state required longevity plan, litigation settlements, workers' compensation, unemployment contribution, vendor price increases, and "Other Direct and Indirect Costs" (ODIC) increases.

<u>85th Legislative Session update</u>: Whereas the mandatory ODIC surcharge has increased in the past, the Department would not have assumed an approx. $2M net increase in one biennium. Had there not been a cost relief factor included in the cost studies, most likely the Department would have be in a situation in 2018-19 of having the Department's appropriations reduced or increase fee rates in order to cover the approx. 21% increase in ODIC costs.

<u>"Other Direct and Indirect Costs" (ODIC) appropriated elsewhere:</u> If it is the Legislature's desire to curb fee increases, then the ODIC model will need to be addressed. Even though many components of ODIC (FICA, health insurance, retirement contribution) are FTE based, the ODIC amount is a fixed amount that does not change based on vacancies. Another component of the ODIC is the allocated portion of the State's retirees' healthcare costs. The Department is at the sole mercy as to what LBB and ERS deem the Department's fair share of the statewide retirees' healthcare costs should be.

***Indirect costs**: The Department could not find where the prior administration had prepared a State indirect cost plan as required under Texas Government Code, Chapter 2106. To be in compliance with the statute, the current* *administration will prepare a written procedure that documents the allocation process used in the cost rate analysis.*

The cost recovery programs account for approx. a third of the Department's headcount and were allocated approx. one third of the indirect administrative costs in the cost rate analysis. The methodology used followed LBB guidelines and was based on FTEs per strategy, adjusted for costs that were funded by other sources of funding such as federal programs. The Pesticide Use cost recovery program was allocated indirect administrative costs in a manner consistent with all other cost recovery programs.

Expected Implementation Dates

- *Direct program costs: Methodology, procedures, and retention of costs estimates for current process - in progress with completion by 3/31/18; the development of a formalized process by 8/31/18*

- *Indirect program costs: Indirect cost plan, procedures, and retention of costs estimates for current process – in progress with completion by 3/31/18; the development of a formalized process by 8/31/18*

Responsible Management Staff

- *Direct program costs: Administrator, Agriculture and Consumer Protection; Director, Field Operations*

- *Indirect program costs: Administrator, Budget and Financial Reporting*

Chapter 2-B

The Department Did Not Adequately Document Its Methodology for Setting Individual Fees in Each Strategy to Recover Estimated Costs

Chapter 2-B Rating:

Medium [9]

After the Department estimated total costs for each strategy in its rate analysis, it reviewed its fee structure, projected how many times it would collect each type of fee, and adjusted individual fee amounts as it determined necessary to recover those estimated costs.

However, the Department did not clearly define or document its methodology for setting fees. For certain fees, the Department asserted that it considered specific factors, such as specialized equipment and time required to complete inspections, when setting fees. For most fees, the Department asserted that it proportionally increased fees as needed to recover costs within each strategy. However, a review of 11 fees in the Department's inspect measuring devices strategy for which the Department did not assert that it considered specific factors showed that the increases ranged from 3 percent to 119 percent. In addition, the Department did not maintain documentation of its methodology for projecting how many times it would collect each type of fee.

Recommendation

The Department should document its methodology for determining the amounts at which it should set individual fees within each strategy to recover estimated costs.

Management's Response

The Department generally agrees with the recommendation.

As mentioned in chapter 2A response, the key operations staff that developed the new fee structures was the staff with the most departmental experience and had been in their positions for more than one administration. The Department relied on these subject matter experts to develop an equitable fee structure to fully recover costs. The methodology followed was to increase the fees across the strategy in relative proportional amounts. The exception to the proportional adjustment was for fees associated with more resource intensive consumer protection activities.

[9] Chapter 2-B is rated Medium because the issues identified present risks or effects that if not addressed could moderately affect the audited entity's ability to effectively administer program(s)/function(s) audited. Action is needed to address the noted concern and reduce risks to a more desirable level.

All fees rates were considered based on specialized equipment needs, time requirements for inspections and current rate. The percentage increases, while varied, were dependent upon these factors and whether a particular fee was subsidized previously by other device fees.

Expected Implementation Dates

- *Methodology and procedures for setting fees: for current process - in progress with completion by 3/31/18; the development of a formalized process by 8/31/18*

Responsible Management Staff

- *Administrator, Agriculture and Consumer Protection*
- *Director, Field Operations*

Appendices

Appendix 1

Objectives, Scope, and Methodology

Objectives

The objectives of this audit were to:

- Assess the Department of Agriculture's (Department) process for setting fees.
- Determine whether the Department has set selected fees in amounts that offset the costs of administering the associated regulatory activities.

Scope

The scope of this audit covered the Department's cost-recovery strategies as defined in the General Appropriations Act (84th Legislature), with a focus on the seven cost-recovery strategies included in the Department's September 2015 *Cost Recovery Rate Analysis* (rate analysis).

Methodology

The audit methodology consisted of evaluating the Department's process for developing the rate analysis it completed in September 2015. That included reviewing support for cost estimates in the rate analysis and the Department's process for setting fees based on those cost estimates. Auditors limited some procedures to the cost-recovery programs within the Department's inspect measuring devices strategy. Auditors also reviewed the Department's comparison of its actual revenues and expenditures for its cost-recovery programs.

Data Reliability and Completeness

The Department provided computer-processed data from the following sources to support the information in its rate analysis:

- The Uniform Statewide Payroll/Personnel System (USPS).
- The Department's Bringing Resources, Integration and Data Together for Greater Efficiency (BRIDGE) licensing and enforcement system.
- The Department's Metro Access database, which the Department uses to track information for its metrology program.

Auditors reviewed the queries that the Department used to extract data from the sources listed above. Auditors used that data to corroborate information in the Department's rate analysis, and determined that the data was sufficiently reliable for that purpose.

Auditors also extracted specific revenue and expenditure data from the Office of the Comptroller of Public Accounts' Uniform Statewide Accounting System (USAS) to corroborate the data in the Department's rate analysis and the Department's comparison of revenues to expenditures. Auditors relied on previous State Auditor's Office audit work on USAS to determine that the data in USAS was sufficiently reliable for those purposes.

Information collected and reviewed included the following:

- The Department's September 2015 *Cost Recovery Rate Analysis.*
- Excel workbooks the Department used to develop its rate analysis.
- Supporting documents, such as price quotes, contracts, and invoices, that the Department used to estimate costs included in the rate analysis.
- Revenue and expenditure data from USAS.
- Payroll data from USPS.
- License, device, inspection, and other information from the Department's BRIDGE system and Metro Access database.

Procedures and tests conducted included the following:

- Interviewed Department management and staff about the Department's process for developing the rate analysis.
- Evaluated the Department's process for developing cost estimates within the three cost categories in the rate analysis: (1) operating costs, (2) direct labor costs, and (3) indirect costs.
- Traced cost estimates in the rate analysis to workbooks and other supporting documentation.
- Evaluated the Department's process for setting fees based on its cost estimates.
- Reviewed and summarized the Department's comparison of actual revenues and expenditures.

Criteria used included the following:

- Texas Agriculture Code, Section 12.0144.
- Texas Government Code, Chapter 2106.
- General Appropriations Act (84th Legislature).

Project Information

Audit fieldwork was conducted from January 2017 through June 2017. We conducted this performance 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 findings and conclusions based on our audit objectives.

The following members of the State Auditor's staff performed the audit:

- Tessa Mlynar, CFE (Project Manager)
- Krista L. Steele, MBA, CPA, CFE, CIA, CGAP (Assistant Project Manager)
- Michael Bennett
- Adam Berry
- Rebecca Franklin, CISA, CFE, CGAP, CICA
- Arnton Gray
- Ann E. Karnes, CPA (Quality Control Reviewer)
- Audrey O'Neill, CIA, CFE, CGAP (Audit Manager)

Issue Rating Classifications and Descriptions

Auditors used professional judgement and rated the audit findings identified in this report. Those issue ratings are summarized in the report chapters/sub-chapters. The issue ratings were determined based on the degree of risk or effect of the findings in relation to the audit objective(s).

In determining the ratings of audit findings, auditors considered factors such as financial impact; potential failure to meet program/function objectives; noncompliance with state statute(s), rules, regulations, and other requirements or criteria; and the inadequacy of the design and/or operating effectiveness of internal controls. In addition, evidence of potential fraud, waste, or abuse; significant control environment issues; and little to no corrective action for issues previously identified could increase the ratings for audit findings. Auditors also identified and considered other factors when appropriate.

Table 2 provides a description of the issue ratings presented in this report.

Table 2

Summary of Issue Ratings	
Issue Rating	**Description of Rating**
Low	The audit identified strengths that support the audited entity's ability to administer the program(s)/functions(s) audited <u>or</u> the issues identified do not present significant risks or effects that would negatively affect the audited entity's ability to effectively administer the program(s)/function(s) audited.
Medium	Issues identified present risks or effects that if not addressed could <u>moderately affect</u> the audited entity's ability to effectively administer program(s)/function(s) audited. Action is needed to address the noted concern(s) and reduce risks to a more desirable level.
High	Issues identified present risks or effects that if not addressed could <u>substantially affect</u> the audited entity's ability to effectively administer the program(s)/function(s) audited. Prompt action is essential to address the noted concern(s) and reduce risks to the audited entity.
Priority	Issues identified present risks or effects that if not addressed could <u>critically affect</u> the audited entity's ability to effectively administer the program(s)/function(s) audited. Immediate action is required to address the noted concern(s) and reduce risks to the audited entity.

Appendix 3

The Department's Overall Statement of Response

TEXAS DEPARTMENT OF AGRICULTURE
COMMISSIONER SID MILLER

August 21, 2017

State Auditor's Office
ATTN: Tessa Mlynar
P.O. Box 12067
Austin, Texas 78711-2067

Subject: Texas Department of Agriculture – Overall Statement regarding Recommendations

I, and the Texas Department of Agriculture, thank the State Auditor's Office for its efforts to review, analyze and report on TDA's cost recovery related fees used to operate TDA's consumer protection programs. In order for industry, government, or the public to understand the difficulties in setting cost recovery fees you must realize that TDA historically had the ability to move monies within the agency to support programs (transfer of funds) that could suffer an operating loss, and could keep and use monies received from fiscal year to fiscal year, and from state budgeting years to future budgeting years (carry forward unexpended balances). TDA no longer has these financial planning tools to use, and must operate in a financial world where the Texas Legislature has removed those budgeting and accounting tools of transfer of funds and carrying forward unexpended balances. TDA has requested the return of those financial planning tools from the Legislative Budget Board (LBB) in years past, but has not received any response to such request. Without these financial tools, it is impossible, or very difficult, for TDA to lower fees in cost recovery programs. If these tools are returned to TDA by LBB we may be able to reduce fees.

TDA is required to submit its budgeting information almost three years in advance of expenditures. However, LBB can impose millions of dollars of additional expenditures (for example, other direct and indirect costs—"odic") that TDA must financially pay for out of cost recovery fees TDA receives. Additionally, TDA must plan for future cost increases, such as rapidly increasing fuel prices, and must absorb expense increases passed through by other agencies, such as the Department of Information Resources and the Legislature (unfunded mandates).

We have provided SAO responses to each of its recommendations. We want to clarify the Department's position on the fee structure and why revenues exceeded expenditures during the 2016-17 biennium.

The new rates went into effect January 1, 2016, and, as expected, revenues exceeded expenditures as was intended in the cost study calculations (you certainly would not want to plan for a loss!).

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- The rates include a cash flow factor (working capital) totaling $2.6M on an annual basis to ensure adequate funds would be available for administering the programs each year, as the Department could not assume that General Revenue (provided by appropriation by the Legislature) would be available.
- The rates also include an amount for unanticipated costs (cost relief factor), totaling $2M on an annual basis, as unexpected events will occur (ie, damage to expensive equipment, unfunded legislative mandates, other agency pass through expenses, and LBB forced payments of other direct and indirect costs), in that not all costs charged to the programs are under the control of the Department but are expected to be funded by the fees collected.

In addition, the Department strives to identify efficiencies throughout all of its programs with the goal of developing more cost effective programs. Some of the efficiencies that have occurred in the cost recovery programs resulted in additional revenue collections (expansion in inspections) plus a reduction in costs for a net savings of approx. $0.8M.

Also, TDA's authority to spend monies was not increased to match the increased revenue collections at the time the rates were implemented. The delay in increasing the Department's expenditure budget in both FY16 and FY17 contributed to Revenue collections exceeding Expenditures. In other words, the Department had the revenue but did not have the authority to spend it even though the expenditures were included in the Cost Study.

The Department was required to place the fee change notifications in the Texas Register, but we did more. In an effort to be transparent on fee changes we published a 94-page document explaining the analysis that was performed to come to the new fee structures. We appreciate the conscientious fee study made by the SAO, and TDA has provided the SAO auditors hundreds of emails and documents, plus spent many hours responding to questions during the audit to support the assumptions made in the Cost Studies.

Throughout the fee setting process, the Department responded to questions asked by members of the Legislature, trade associations, Legislative Budget Board staff, Comptroller's Office staff, and through public information act requests ("PIRs") to arrive at fees that would be fair, comprehensive, and give the Texas Department of Agriculture the ability to protect the citizens of Texas.

Sincerely,

Sid Miller
Commissioner

Copies of this report have been distributed to the following:

Legislative Audit Committee

The Honorable Dan Patrick, Lieutenant Governor, Joint Chair
The Honorable Joe Straus III, Speaker of the House, Joint Chair
The Honorable Jane Nelson, Senate Finance Committee
The Honorable Robert Nichols, Member, Texas Senate
The Honorable John Zerwas, House Appropriations Committee
The Honorable Dennis Bonnen, House Ways and Means Committee

Office of the Governor

The Honorable Greg Abbott, Governor

Department of Agriculture

The Honorable Sid Miller, Commissioner