

CALIFORNIA STATE AUDITOR

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Department of General Services: Review of Strategic Sourcing and Impacts on Small Business

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SUMMARY

The California State Auditor has issued two audit reports on the State's contracting practice that involve small businesses or Disabled Veteran Business Enterprises (DVBEs).

- July 2002: *Disabled Veteran Business Enterprise Program: Few Departments That Award Contracts Have Met the Potentially Unreasonable Participation Goal, and Weak Implementation of the Program Further Hampers Success* (Report 2001-127).
- July 2010: *Department of General Services: It No Longer Strategically Sources Contracts and Has Not Assessed Their Impact on Small Businesses and Disabled Veteran Business Enterprises* (Report 2009-114).

Our 2002 report concluded that many awarding departments did not report DVBE participation to the Department of General Services (General Services) as required by statute. Of those that did report, most did not meet the 3 percent participation goal established under the DVBE program. Additionally, the methodology for reporting DVBE participation levels was flawed. The reasonableness of the 3 percent goal itself was uncertain, and a thorough study of the businesses owned by disabled veterans was needed to determine an appropriate goal. Additional factors also impeded the State's ability to meet the 3 percent goal. Awarding departments had great flexibility in implementing the program, leading to inconsistent and weak implementation. Some awarding departments exempted a significant number of contracts, did not scrutinize good-faith effort documentation that bidders submitted as a substitute for subcontracting with DVBEs, and did not take steps to ensure DVBEs were used according to contract specifications.

In the 2002 report, we made several recommendations to state agencies, including General Services and the Department of Veterans Affairs. These recommendations focused on a variety of areas, such as reporting, monitoring, and outreach. As part of what was then our standard follow-up process, the state agencies to which we made our recommendations reported on their status three times within the first year after our report was issued. In February 2004 we last reported to the Legislature that most of the recommendations to state agencies had been partially implemented. We also made recommendations that we asked the Legislature to consider. Subsequent to our report, there have been several laws enacted that modified the State's contracting practices with DVBEs.

Our presentation today focuses on our 2010 report, which is our most recent work involving small businesses and DVBEs. We will present the key issues in the report, as well as the latest information that we have received regarding the implementation of the recommendations we made during the audit. The Joint Legislative Audit Committee requested that we review General Services' strategically sourced contracting practices and the effects these practices have on California small businesses and DVBEs. Although our audit focused on strategically sourced contracts, the policy questions we identified during the audit are also applicable to other types of statewide contracts that the State implements to take advantage of volume discounts. A key policy question is as follows: Is it in the State's best interest to limit a particular line of business to a select number of small businesses and DVBE subcontractors rather than the many small businesses and DVBEs that could contract with the State?

BACKGROUND

General Services' Role and Responsibilities

General Services serves as the business manager for the State and has the authority to establish various types of contracts that leverage the State's purchasing power. State law provides General Services with broad powers for carrying out its responsibilities. For example, it has general powers of supervision over all matters concerning the financial and business policies of the State as they relate to its duties. State agencies are generally not permitted to acquire goods costing more than \$100 without General Services' supervision. General Services can delegate purchasing authority to state agencies that meet specific criteria for purchases that exceed that amount. Under their delegated authority, state agencies can enter into contracts up to a specified dollar amount as defined by the level of purchasing authority that General Services grants. All purchases that exceed a state agency's delegated purchasing authority must be contracted by General Services on that agency's behalf. Depending on the volume of purchases of certain goods, General Services might enter into a statewide contract for state agencies to use when purchasing goods.

In June 2004 General Services awarded a three-year contract to CGI-American Management Systems (CGI) to assist General Services in implementing its strategic sourcing initiative. The purpose of strategic sourcing was to enter into statewide contracts that leveraged the State's purchasing power to save money on the goods and services purchased most frequently by state agencies. The strategic sourcing process involved identifying those goods and services through a systematic analysis of past purchasing data and projecting the savings that could be expected through new contracts.

Small Business and DVBE Participation Requirements

In an effort to increase small business and DVBE participation, state law and regulations require agencies that award contracts provide preferences and incentives to these firms. State law requires state agencies to give a 5 percent preference to California small business bidders meeting specifications. Before October 2007 General Services' policy for itself and agencies with delegated authority allowed a 3 percent to 10 percent incentive for DVBE participation. In October 2007 a regulation was established limiting the DVBE incentive to no less than 1 percent and no more than 5 percent.

Participation goals also exist. By executive order, a goal was set for all state agencies to award at least 25 percent of their contract dollars to small businesses. Further, state law establishes a 3 percent DVBE participation goal that applies to state agencies' overall annual expenditures for contracts. Before a change in law that became effective July 2009, bidders could meet a DVBE participation effort requirement or perform a good-faith effort to meet the requirement. With the change in law, the good-faith effort is no longer an option and, for individual solicitations in which a state agency includes a DVBE goal, bidders actually must meet the specified DVBE goal to be considered for contract award.

AUDIT HIGHLIGHTS

Our July 2010 review of General Services' strategically sourced contracting practices revealed that it:

- Awarded 33 statewide strategically sourced contracts for 10 categories of goods between February 2005 and July 2006. Further, it:
 - Accrued at least \$160 million in net savings as of June 30, 2007.
 - Paid the consultant that assisted in implementing the strategic sourcing initiative 10.5 percent of the accrued savings realized through these contracts.
 - Did not continue to formally calculate the savings after June 2007 when its consulting contract expired.
- Has not strategically sourced 20 other categories of good or services, which were recommended by the consultant, and had not prepared an analysis to document its rationale for not strategically sourcing.
- Incurred significant costs to train staff and to develop written procedures on strategic sourcing, yet has not awarded any new strategically sourced contracts using the procedures or reviewed comprehensive purchasing data to identify new opportunities.
- Lacks data to determine the impact of strategic sourcing on the participation by small businesses and DVBEs.
- Does not monitor small business and DVBE subcontractors to ensure that they perform commercially useful functions in providing goods or services once a contract has been awarded.
- Does not have standard procedures to recover any overcharges identified despite its new automated process designed to monitor compliance with contract pricing terms.

General Services' Initial Strategic Sourcing Efforts Resulted in Significant Savings

General Services awarded a contract in June 2004 to CGI to assist it in identifying and creating strategically sourced contracts. The contract required General Services to pay CGI 10.5 percent of the first \$400 million in accrued savings realized through these contracts until June 2007, when the CGI contract expired.

Based on CGI's recommendations, General Services awarded 33 strategically sourced contracts for 10 categories of goods. These categories, which included goods such as information technology hardware, office equipment, and pharmaceuticals, comprised \$532.8 million in historical annual purchases.

CGI identified the cost the State would have incurred had it not strategically sourced the goods by applying historical prices and discounts the State received in the past to the purchases it made during the period for which CGI was calculating the savings. It also calculated the cost the State incurred by applying the strategically sourced contract prices to the purchases it made during the same period. The difference represented the accrued savings. General Services reviewed the savings calculations before paying CGI.

The savings calculations indicated that between February 2005 and June 2007, the State incurred \$179 million less in costs for purchases under the strategically sourced contracts. General Services paid CGI fees of \$18.8 million. Therefore, documents indicate that the net accrued savings from the contracts through June 2007 was \$160 million.

At the time of our July 2010 audit, 28 of the original 33 contracts had expired, with the remaining five scheduled to expire by July 2010. Although 26 of the 28 expired contracts had been rebid or extended, management acknowledged that the historical information used by CGI in measuring related savings may no longer be relevant because that information was based on purchases during fiscal years 2002–03 and 2003–04.

General Services Had Not Entered Into New Strategically Sourced Contracts

General Services created an Intake and Analysis Unit (IAU) in 2006 to review new contract requests from state agencies and the State's contract expenditure patterns to identify strategic sourcing opportunities. The IAU performed opportunity assessments, which is the first step required by its procedures manual to identify potential categories to strategically source; however, General Services had not awarded any new strategically sourced contracts using these procedures.

In particular, General Services did not strategically source 20 other categories of goods or services that CGI recommended. These additional categories included telecommunications, architectural and engineering services, leased real property, and personnel services. General Services indicated that the State has used traditional methods to issue statewide contracts from many of the categories. However, it had not determined that these contracts have resulted in savings commensurate with what it would have achieved under strategic sourcing.

General Services was not reviewing comprehensive purchasing data that would allow it to effectively identify any new opportunities. Instead, when it performed opportunity assessments to determine if strategic sourcing was warranted, General Services primarily considered the usage information it received for existing statewide contracts.

General Services planned to use the data in the State Contracting and Procurement Registration System (SCPRS), a database state agencies use to input information related to purchasing documents, for strategic sourcing purposes. However, SCPRS data can be unreliable and do not have the level of detail necessary to allow General Services to identify the specific goods purchased. Until General Services obtains a comprehensive source of statewide data, obtaining detailed purchasing data useful for strategic sourcing purposes will involve using SCPRS as a starting point to target potential opportunities and then working with selected state agencies to obtain the necessary data.

Effects of Strategic Sourcing on Small Business and Disabled Veteran Business Enterprises Are Not Known

Strategically sourced contracts present a trade-off between conflicting state goals. Specifically, strategic sourcing achieves lower prices by consolidating state expenditures into fewer contracts and thus taking advantage of volume discounts. However, consolidating state contracts can result in fewer contracting opportunities for small businesses and DVBEs.

General Services did not track the effect an individual type of acquisition methodology, such as strategic sourcing, has on contracting with small businesses and DVBEs, nor did it have all the information necessary to measure the effect. For example, it did not have participation data showing the number of small businesses and DVBEs for contracts of categories of goods that subsequently were strategically sourced.

As previously mentioned, by executive order, a goal was set for all state agencies to award at least 25 percent of their contract dollars to small businesses. Further, state law establishes a 3 percent DVBE participation goal that applies to state agencies' overall annual expenditures for contracts.

To provide state agencies with alternative means of achieving small business and DVBE goals, General Services inserted an “off-ramp” clause in strategically sourced contracts, as it did with some other mandatory statewide contracts, to allow agencies the option to forgo purchasing from the mandatory vendor and to contract with small businesses and DVBEs directly. However, General Services did not have information regarding how often state agencies have used the off ramp for contracts, choosing not to track this information because it believes the individual agency is responsible for monitoring its achievement against goals.

State agencies annually report participation data to General Services that include the total number and dollar amounts of contracts awarded to small businesses and DVBEs, and General Services used this information to prepare a consolidated report, as required by state law. However, limitations largely hindered the use of these data in determining the impact of strategic sourcing. For example, not all agencies submitted a report every year, and in no year did the annual report isolate participation levels for the subset of goods included in the strategically sourced contracts.

As the information in the annual reports was the best information available, we analyzed the reported dollars and numbers of contracts awarded by five large state agencies during a seven-year period (that included fiscal years before and after the start of strategic sourcing). However, the data did not indicate a clear relationship between participation and strategic sourcing, and we learned that the data contained errors. For example, the California Department of Corrections and Rehabilitation explained to us that it underreported by nearly 29,000 the number of small business contracts it awarded in fiscal year 2006–07.

General Services Does Not Monitor for Ongoing Compliance With Commercially Useful Function Requirements

State law requires that small businesses and DVBE contractors and subcontractors participating in state contracts must perform commercially useful functions in providing goods or services that contribute to the fulfillment of the contract requirements. Such requirements are designed to ensure that the firms play a meaningful role in any contract in which they participate.

To perform a commercially useful function, a person or an entity must do all of the following:

1. Be responsible for executing a distinct element of the work of the contract.
2. Actually perform, manage, or supervise the work involved.
3. Perform work that is normal for its business services and functions.
4. Not further subcontract a portion of the work that is greater than that expected to be subcontracted by normal industry standards.

General Services requires bidders to identify in their bids the goods or services that each small business and DVBE subcontractor will provide, and it relies upon their assertions to assess whether the subcontractors’ roles will meet the commercially useful function requirements. Although it may request that bidders clarify their plans, General Services did not monitor subcontractors to ensure that they comply with these requirements once the contract was awarded.

General Services’ management commented that the individual state agency making the purchase is responsible for validating that subcontractors complied with commercially useful function requirements. Management pointed to a *State Contracting Manual* section as addressing the state agencies’ responsibilities in this area. However, the *State Contracting Manual* does not provide specific guidance on how state agencies are expected to verify that subcontractors actually performed commercially useful functions.

Questions Have Been Raised Regarding the Role of Subcontractors on a General Services' Contract

In August 2006 General Services awarded the office supplies contract to Office Depot, which proposed to use a combination of nine small business and DVBE subcontractors to fill most of the orders placed by the State. Although the subcontractors would follow up on the orders and invoice the state agencies for them, Office Depot would package and ship the goods from its warehouse without subcontractors taking physical possession of the goods. Several small businesses questioned whether these subcontractors complied with certain contract provisions, including commercially useful function requirements, which prompted General Services to request an internal audit.

The internal auditors concluded that the subcontractors complied with the commercially useful function requirements. In particular, the report noted that General Services' legal counsel indicated that a small business or DVBE does not need to take physical possession of the contracted goods to comply with the requirements. The legal counsel advised that, according to the California Commercial Code, the title to goods passes from the seller to the buyer in any manner explicitly agreed upon by the parties.

The internal auditors noted some limitations in documentation during their review. For example, the report noted that, at the time of the review, General Services' policies did not require the completion of a specific work sheet or other document to capture the results of the assessment as to whether the bid complied with commercially useful function requirements.

The report by the internal auditors highlighted the amount of discretion possible when General Services verified that proposed work was within each firm's line of business. For example, the internal auditors confirmed that one small business subcontractor was not a seller of goods at the time of the contract award. Although they acknowledged that this condition raised concerns about the firm's apparent lack of experience, they noted that state law and policy does not prevent an existing firm from entering into a new line of business to participate into a state contract.

Although the internal auditors' review found no indication that the Office Depot contract violated state laws governing commercially useful function requirements, the contract raised the following policy questions that we suggested the Legislature may want to consider further:

- Is a business relationship such as the one between Office Depot and its subcontractors what the Legislature envisioned when it created the commercially useful function requirements?
- Should a firm be required to have demonstrated experience in a particular line of business before being allowed to participate in state contracts?
- Considering the tasks contracted were of a nature that Office Depot was capable of performing, should the State prohibit contractors from subcontracting with small businesses and DVBEs under such circumstances at the cost of eliminating participant opportunities for these entities?
- Is it in the State's best interest to limit a particular line of business, such as office supplies, to a relatively small number of small businesses and DVBE subcontractors rather than the many small businesses and DVBEs that could contract with the State?

General Services' New Process for Verifying Pricing Compliance Needs Further Attention

General Services began an automated process of ensuring contractors' compliance with contract pricing terms in August 2008 when it implemented the Compliance and Savings Administration (CASA) system.

Our review of selected items found that although the CASA system appropriately processed usage data reported by contractors and identified discrepancies between the prices in usage reports and the respective contract's pricing terms, General Services had not yet developed standard procedures to recover overcharges.

General Services relied on the usage data reported by contractors to ensure compliance with contract pricing, but it did not verify the data for accuracy. Thus, General Services could not be assured that its efforts to ensure pricing compliance are meaningful.

General Services' management commented that individual state agencies making the purchases are responsible for ensuring that the contractor invoiced them for correct amounts in accordance with the contract. However, discrepancies identified by the CASA system demonstrate that state agencies are not always performing this task effectively.

The following pages identify the multiple recommendations we made in the July 2010 report, the December 2010 status on implementing them, and our assessment of the status.

Partially Implemented

General Services states that it has developed standards for implementing and documenting the evaluation of recent purchase patterns when determining whether to extend, rebid or retire previously sourced contracts. It notes that it did so in July 2010 by updating its procedures manual to incorporate detailed requirements for the development of opportunity assessments and sourcing work plans.

General Services also states that it is piloting the use of a work plan template that contains detailed information on savings expected from the proposed source contract. It expects to complete the pilot project and incorporate lessons learned into a final work plan template in June 2011. It subsequently plans to compare the baseline savings amounts to the actual pricing obtained under an executed contract to calculate achieved savings.

General Services completed its review of CGI-recommended categories that it did not strategically source and concluded that none of the 20 categories warranted additional strategic sourcing contracting efforts. General Services noted that its review confirmed that it used other traditional acquisition techniques to acquire those goods or services that accomplished the same goal as strategic sourcing. It noted that for the remaining categories, such as architectural and engineering services, electricity, and leased real property, the review determined that the categories were of such a broad nature that strategic sourcing techniques could not be applied.

In response to our request for documentation of the analysis performed that resulted in its conclusions, General Services provided a document of about three pages. The document commented on the results of each of the categories for which it or others conducted traditional acquisition methods. For many of the categories, General Savings indicated that either savings would be measured by individual contract or savings were not measured. Additionally, General Services described the factors that it believes prevent strategic sourcing of other categories.

To ensure that it determines savings to the State going forward for strategically sourced contracts, General Services should examine the State's recent purchasing patterns when determining whether to rebid or extend previously strategically sourced contracts and when estimating expected savings. It should subsequently compare the savings it achieves to the expected savings for those contracts.

To ensure that it has maximized the savings for CGI-recommended categories that it did not strategically source, General Services should conduct its planned review of these categories to determine if there are further opportunities to achieve savings.

Implemented: General Services completed its planned review.

However, we note that General Services' review was unable to report aggregate savings information for many of the categories for which it indicated traditional acquisition techniques were used. This underscores the need for General Services, as it implements our recommendations regarding future purchases, to ensure that it is tracking actual savings in such a way that it can compare them against expected savings.

To ensure that it maximizes the savings to the State for future purchases, General Services should follow the procedures for identifying strategic sourcing opportunities included in the Intake and Analysis Unit's procedures manual. To ensure that it is effectively identifying new strategic sourcing opportunities, General Services should work to obtain comprehensive and accurate data on the specific items that state agencies are purchasing, including exploring options for obtaining such data for agencies that do not have enterprise-wide systems and therefore would not be using the additional functionality of the eProcurement system.

Until it obtains such data, General Services should work with state agencies to identify detailed purchases for categories that it identifies through the State Contracting and Procurement Registration System (SCPRS) as viable opportunities for strategically sourcing. For example, if based on its review of SCPRS data, General Services identifies a particular category that it believes is a good candidate for strategic sourcing, it should work with those state agencies that accounted for the most purchases within the category to determine the types and volume of specific goods purchased to further analyze the types of goods to strategically source. General Services should assess any need for additional resources based on the savings it expects to achieve.

To provide decision makers with the information necessary to determine the true costs and benefits of strategic sourcing, General Services should evaluate any impact strategic sourcing has on small business and DVBE participation in terms of number of contracts awarded and amounts paid to small businesses and DVBEs within the categories being strategically sourced. Specifically, for goods that were strategically sourced, General Services should compare the number of contracts awarded to small businesses and DVBEs before they were strategically sourced with those awarded through such contracts after they were strategically sourced. This effort should include contracts awarded by General Services and other state agencies.

General Services indicates that it periodically reviews databases, including the SCPRS data, for items that may indicate a strategic sourcing opportunity. It states that in consultation with its customers, it uses available data on purchasing patterns to identify if strategic sourcing or another procurement vehicle should be used. General Services believes that these steps are sufficient to allow it to obtain comprehensive and accurate data on the specific items that state agencies are purchasing that are of a volume that warrant an opportunity for strategic sourcing. General Services states that it goes through an extensive search for purchasing data using all available sources and that it requests copies of purchase orders from state agencies to obtain more detailed purchasing data.

Pending: It is unclear to what extent General Services implemented new procedures since the audit.

General Services states that before performing an acquisition, it includes an assessment of the number of small businesses and DVBEs that participated in the previous solicitation and the potential number of small businesses and DVBEs that will be participating in the new solicitation. As for tracking the use of small business and DVBE firms after a strategically sourced contract has been awarded, General Services has decided to capture and track that information for each statewide contract under its purview.

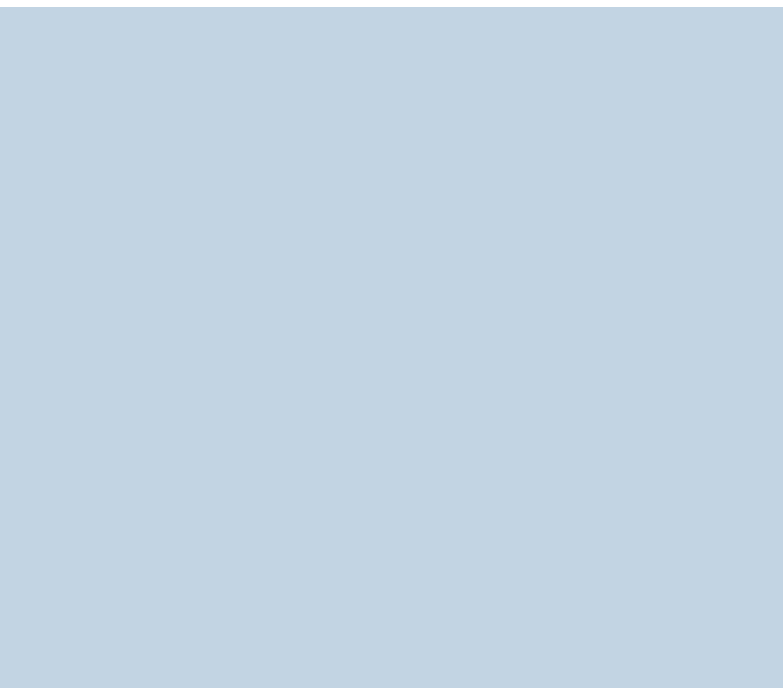
Partially Implemented

STATE AUDITOR'S ASSESSMENT OF IMPLEMENTATION STATUS

DEPARTMENT OF GENERAL SERVICES' UPDATE ON IMPLEMENTING RECOMMENDATIONS (DECEMBER 3, 2010)

CALIFORNIA STATE AUDITOR RECOMMENDATIONS

<p>To evaluate the effectiveness of the off ramp in providing opportunities for small business and DVBE participation, General Services should track the number and dollar amounts of contracts that state agencies award through the use of the off ramps in strategically sourced and other mandatory statewide contracts. General Services' evaluation also should consider the extent to which an off ramp affects the monetary benefits that result from statewide contracts designed to leverage the State's purchasing power.</p>	<p>General Services states that it is maintaining a database for tracking purposes of approved small business or DVBE off-ramp purchases, which includes pricing information. It plans to use this information to assess the impact on small businesses and DVBEs after strategic sourcing. General Services is piloting the new off-ramp usage tracking process using one statewide contract and anticipates completing the pilot phase and finalizing procedures within the first quarter of the 2011 calendar year.</p>	
<p>To ensure that small business and DVBE subcontractors comply with the commercially useful function requirements, General Services should develop guidance for state agencies on how to ensure that subcontractors perform commercially useful functions if it believes state agencies making the purchases through statewide contracts should be responsible for this task. In addition, General Services should monitor, on a sample basis, whether state agencies are ensuring compliance with these requirements. General Services could leverage its efforts by working with other state agencies to ensure that subcontractors claiming to have provided the goods and services to the purchasing agency did, in fact, perform the work for which they are invoicing the state agencies.</p>	<p>General Services states that it will ensure that user instructions for future statewide contracts contain provisions that fully inform the user state agency of commercially useful function requirements. Further, it notes that it is in the process of implementing the use of contract management plans that clearly document the responsibilities of its contract administrators. Where applicable, these plans are to include a requirement for ensuring, on at least a sample basis, contractor compliance with commercially useful function requirements. General Services reports that policies and procedures for implementing the contract management plan process are currently in draft form with finalization expected within the first quarter of the 2011 calendar year.</p>	<p>Partially Implemented</p>
<p>To ensure prompt recovery of state funds, General Services should implement standard procedures to recover overcharges identified by the Compliance and Savings Administration system. General Services' new procedures should specify the amount of time it considers reasonable to recover funds due back to the State.</p> <p>To improve the integrity of its monitoring of pricing compliance, General Services should implement procedures to help ensure that usage reports reflect the actual items received and prices paid by the state agencies that purchased the items. For example, on a periodic basis, it could select a sample of purchases from the usage reports and work with purchasing state agencies to confirm that the prices and quantity of items reported reconcile with the invoices submitted by the contractor.</p>	<p>General Services is developing standard procedures to recover any overcharges, including the amount of time considered reasonable to recover funds due back to the State. The procedures are to provide for the prompt issuance of a "cure letter" upon identification of an overcharge amount. General Services states that it will also promptly follow up to collect any delinquent amounts. It reports that the procedures are in the final stages of completion and anticipates implementation within the first quarter of 2011.</p> <p>General Services plans to implement procedures to assist in ensuring the accuracy of the usage reports submitted by contractors. The contract management plan process mentioned in General Services' comments on the recommendations related to commercially useful function requirements is to include steps for the contract administrator to work with state agencies to confirm the accuracy of contractor report pricing and other relevant data. To ensure the validity of the contractor's usage reporting, the steps are to include sampling purchasing agency documents and reconciling that data with usage report information.</p>	<p>Partially Implemented</p>



To provide further clarity regarding the use of small business and DVBE subcontractors on state contracts, the Legislature should consider the policy questions associated with the Office Depot contract as follows:

- Is a business relationship such as the one between Office Depot and its subcontractors what the Legislature envisioned when it created the commercially useful function requirements?
- Should a firm be required to have demonstrated experience in a particular line of business before being allowed to participate in state contracts?
- Considering the tasks contracted were of a nature that Office Depot was capable of performing, should the State prohibit contractors from subcontracting with small businesses and DVBEs under such circumstances at the cost of eliminating participant opportunities for these entities?
- Is it in the State's best interest to limit a particular line of business, such as office supplies, to a relatively small number of small businesses and DVBE subcontractors rather than the many small businesses and DVBEs that could contract with the State in the absence of strategic sourcing?

The Legislature should then revise state law as it deems appropriate.