

Department of General Services:

It No Longer Strategically Sources Contracts and
Has Not Assessed Their Impact on Small Businesses
and Disabled Veteran Business Enterprises

July 2010 Report 2009-114



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July 8, 2010

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The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the California State Auditor presents this audit report concerning the Department of General Services' (General Services) strategically sourced contracting practices and the effects these practices have on California small businesses and Disabled Veteran Business Enterprises (DVBES). This report concludes that documents indicate that as a result of its initial strategic sourcing efforts, the State accrued at least \$160 million in net savings from 33 contracts through June 30, 2007. General Services stopped formally calculating savings at that time. Further, although it has not strategically sourced 20 other categories of goods or services that its consultant recommended, General Services indicates that it has used traditional methods to issue statewide contracts for many of the categories. However, it has not determined that these contracts have resulted in savings commensurate with what it would have achieved under strategic sourcing. General Services has not entered into any strategically sourced contracts since July 2006, and it is not reviewing comprehensive purchasing data that will allow it to identify new opportunities effectively.

General Services does not have all the necessary data to determine the change in the number of small businesses and DVBES participating in a category of goods that was strategically sourced. Additionally, our review of contracts awarded to small businesses and DVBES by five large state agencies does not indicate a clear relationship. Further, General Services determines whether the planned use of subcontractors complies with statutory requirements designed to ensure that they play a meaningful role in any contract in which they participate. However, it does not monitor to ensure compliance once the contract has been awarded. Finally, General Services does not yet have standard procedures to recover state funds when it identifies a contractor that has not complied with the pricing terms of the contract.

Respectfully submitted,



ELAINE M. HOWLE, CPA
State Auditor

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Contents

Summary	1
Introduction	7
Audit Results	
A Consulting Firm Assisted the Department of General Services in Implementing the Strategic Sourcing Initiative	15
General Services' Initial Strategic Sourcing Efforts Resulted in Significant Savings	17
General Services Has Not Entered Into New Strategically Sourced Contracts	22
Effects of Strategic Sourcing on Small Businesses and Disabled Veteran Business Enterprises Are Not Known	27
General Services Does Not Monitor for Ongoing Commercially Useful Function Compliance	35
Questions Have Been Raised Regarding the Role of Subcontractors on a General Services' Contract	38
General Services' New Process for Verifying Pricing Compliance Needs Further Attention	41
Recommendations	46
Appendix	
Events Related to the Contract Awarded to Office Depot	51
Agency Response	
State and Consumer Services Agency, Department of General Services	55
California State Auditor's Comments on the Response From the Department of General Services	63

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Summary

Results in Brief

The Department of General Services (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 buying power. State law provides General Services with broad powers for carrying out its responsibilities. Depending on the volume of purchases for certain goods, General Services might enter into a statewide contract for state agencies to use in meeting their needs. In June 2004, in anticipation of a recommendation by the governor's California Performance Review, General Services awarded a three-year contract to CGI-American Management Systems (CGI) to assist 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 what savings could be expected through the new contracts. Based on CGI's recommendations, General Services awarded 33 statewide contracts for 10 categories of goods between February 2005 and July 2006.

General Services' documents indicate that the State accrued at least \$160 million in net savings as of June 30, 2007, as a result of its initial strategic sourcing efforts through CGI. The contract required General Services to pay CGI 10.5 percent of the accrued savings realized through the strategically sourced contracts. Accrued savings were computed based on the difference between historical prices and the new contract prices, and our review of some of the savings calculations found them to be accurate. We also performed selected calculations using the actual prices paid by state agencies for goods purchased under the strategically sourced contracts, which sometimes differed from contract prices because state agencies negotiated lower prices than the maximum prices established in the contracts or because they paid more than stated in the contract. Nevertheless, the accrued savings calculations we reviewed were either less or very close to the actual savings realized by the State. General Services did not continue to formally calculate the savings after June 2007, when it no longer used those figures to determine the payment to CGI. General Services has since rebid or extended many of these statewide contracts. Its management acknowledges that the State's purchasing information from fiscal years 2002-03 and 2003-04, which was used by CGI in recommending strategically sourcing various goods and services and measuring related savings, may no longer be relevant.

Audit Highlights . . .

Our review of the Department 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 Disabled Veteran Business Enterprises (DVBES).*

continued on next page . . .

» *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.*

Therefore, General Services would need to examine the State's recent purchasing patterns to determine the savings it can expect on various items.

Further, although General Services has not strategically sourced 20 other categories of goods or services that CGI recommended, it indicates that the State has awarded contracts to address many of these categories. However, we found that General Services had not prepared any kind of comprehensive analysis documenting its attempts to strategically source these categories or its rationale for not strategically sourcing. General Services states that CGI's strategic sourcing method is very resource-intensive. It noted that working within the current fiscal environment, it has used traditional methods of awarding contracts that it believes have achieved savings similar in significance to strategic sourcing. However, General Services has not determined that these contracts have resulted in savings to the State commensurate with what it would have achieved had it used strategic sourcing. Although the information provided by General Services during our audit indicated the savings may be considerably less than what CGI once estimated, General Services told us that it would again review the categories under its purview to determine if there are further opportunities to achieve savings.

General Services created its Intake and Analysis Unit (IAU) in 2006 to, among other duties, identify strategic sourcing opportunities. Further, General Services incurred significant costs by contracting with CGI to train IAU staff and to develop written procedures on strategic sourcing. The IAU does perform opportunity assessments, which are the first step required by its procedures manual to identify new items to strategically source. However, General Services has not awarded any new strategically sourced contracts using the procedures. Additionally, it is not reviewing comprehensive purchasing data that will allow it to identify new opportunities effectively. Instead, when it performs opportunity assessments to determine if strategic sourcing is warranted, it primarily considers the usage information it receives for existing statewide contracts. In addition to ensuring that it has maximized whatever savings are available in the categories that CGI recommended, General Services needs to consider new strategic sourcing opportunities through a detailed review of the State's purchasing patterns.

General Services' management noted that they plan to use the data in the State Contracting and Procurement Registration System (SCPRS) for strategic sourcing purposes. SCPRS is a database state agencies use to input information related to purchasing documents, such as contracts exceeding \$5,000. 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. Management stated that SCPRS, although not perfect, will give General Services an estimated valuation of expenditures by category to consider. Their comments indicate that until they obtain 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.

General Services takes steps to ensure that small businesses and Disabled Veteran Business Enterprises (DVBES) are given equitable opportunities to be chosen for a contract. However, the very nature of strategic sourcing, which consolidates expenditures into statewide contracts to achieve lower prices, also can result in fewer contracting opportunities for small businesses and DVBES. For certain mandatory statewide contracts, including strategically sourced contracts, General Services provides state agencies with the option to contract directly with small businesses and DVBES in order to meet their required participation goals.

Nevertheless, the extent to which strategic sourcing has affected the number of small businesses and DVBES contracting with the State is unclear. General Services does not have all the necessary data to determine the change in the number of these entities participating in a category of goods that was strategically sourced. Our review of all contracts awarded to small businesses and DVBES by five large state agencies, which was based on reported data that was limited in its usefulness, does not indicate a clear relationship. Without such data, General Services cannot measure the impact of strategic sourcing on the participation by small businesses and DVBES. As a result, decision makers do not have adequate information to determine the true cost and benefit to the State of strategic sourcing.

State law requires that small businesses and DVBES must perform commercially useful functions in providing goods or services that contribute to the fulfillment of a state contract. Such requirements are designed to ensure that the firms play a meaningful role in any contract in which they participate. When awarding contracts, General Services primarily relies on attestations by the firms that they will meet these requirements. Further, it does not monitor small business and DVBE subcontractors to ensure that they comply once the contract has been awarded. That General Services does not verify the intended functions of each subcontractor before the award of the contract is reasonable, as these intentions represent a plan that has not yet been enacted. However, we believe General Services should verify, for a sample of contracts, that subcontractors are performing commercially useful functions after

the contracts are awarded. This is especially important because questions have been raised about the roles of small businesses and DVBEs involved in one of General Services' contracts. We believe the contract raises policy questions about the use of subcontractors that the Legislature may want to consider further.

Although General Services has a new automated process to monitor whether contractors are complying with contract pricing terms, it does not have standard procedures to recover any overcharges identified. Additionally, General Services relies on contractors to provide the data related to the quantity purchased by state agencies and the prices they paid without verifying that the data are accurate, so it cannot be assured that its efforts to ensure pricing compliance are meaningful. General Services believes individual state agencies making the purchases are responsible for ensuring that contractors charge them correct amounts. However, discrepancies identified by General Services' new compliance process demonstrate that state agencies are not always performing this task effectively.

Recommendations

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

To ensure that it maximizes savings to the State for future purchases, General Services should follow the procedures for identifying strategic sourcing opportunities included in the IAU's procedures manual. To ensure that it is identifying new strategic sourcing opportunities effectively, General Services should work to obtain comprehensive and accurate data on the specific items that state agencies are purchasing. Until it obtains such data, General Services should work with state agencies to identify detailed purchases for categories that it identifies through SCPRS as viable opportunities for strategically sourcing. General Services should assess any need for additional resources based on the savings it expects to achieve.

To determine the true cost and benefit 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 amount paid to small businesses and DVBEs within the categories being strategically sourced.

To ensure that small business and DVBE subcontractors comply with the commercially useful functions requirements, General Services should monitor, on a sample basis, their compliance with these requirements after a contract has been awarded.

To ensure prompt recovery of state funds, General Services should implement standard procedures to recover any overcharges to state agencies identified through its review of pricing compliance. Also, to improve the integrity of its monitoring of pricing compliance, General Services should implement procedures to help ensure that usage reports reflect the actual goods received and prices paid by the state agencies that purchase items.

Finally, to provide further clarity regarding the use of small business and DVBE subcontractors on state contracts, the Legislature should consider the policy questions we raise in this report and revise state law as it deems appropriate.

Agency Comments

General Services stated that it is fully committed to promptly and completely addressing the issues identified in the audit report. It outlined the actions it will take or has begun taking to address each recommendation.

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Introduction

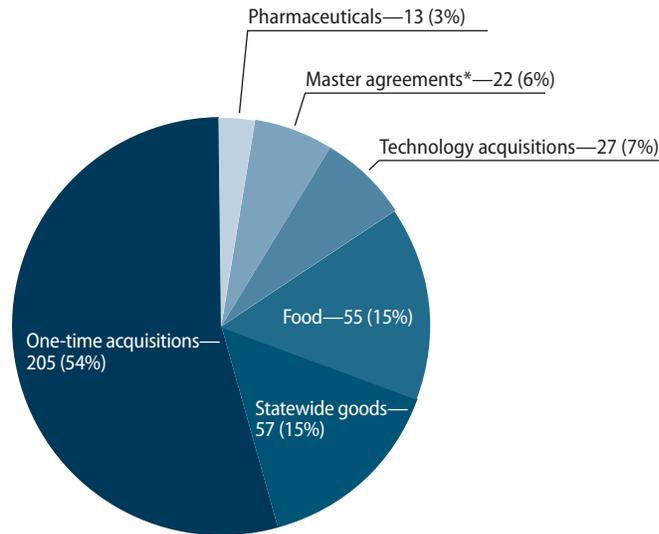
Background

The Department of General Services (General Services) provides centralized services to the State, including purchasing, printing, architectural services, administrative hearings, and accounting services, as well as the planning, acquisition, construction, and maintenance of state buildings and properties. It serves as the business manager for the State and has the authority to establish various types of contracts that leverage the State's buying 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. In addition, it is authorized to examine state agency records.

State agencies generally are not permitted to acquire goods costing more than \$100 without General Services' supervision. In accordance with state law, General Services can delegate purchasing authority to state agencies that meet specific criteria for purchases that exceed \$100. 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 as a one-time acquisition. 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.

Various divisions and offices within General Services award the different types of contracts, including construction and printing. Its Procurement Division is responsible for statewide goods contracts and one-time acquisitions of goods and information technology services. As Figure 1 on the following page shows, statewide goods contracts made up a relatively small proportion of the total number of contracts the Procurement Division reported it awarded during fiscal year 2008–09. Conversely, one-time acquisitions made up more than half of all contracts the Procurement Division awarded. However, the contract value for one-time acquisitions averaged about \$250,000, and contract periods were often short. In contrast, the statewide goods contracts typically last several years and can involve millions of dollars in purchases by multiple state agencies. General Services' policy calls for it to focus its strategic sourcing efforts on these two types of contracts. We discuss the extent to which General Services has implemented this policy in the Audit Results section of this report.

Figure 1
Number and Types of Contracts Issued by the Department of General Services' Procurement Division During Fiscal Year 2008–09



Sources: Data compiled by the Department of General Services' (General Services) Intake and Analysis Unit based on various units' contract counts.

* Master agreements consist of contracts that are competitively bid by General Services. Such agreements establish prequalified lists of vendors and simplify the purchasing process for state agencies.

Implementation of Strategic Sourcing

In February 2004 the governor issued an executive order creating the California Performance Review (CPR). The goal of the CPR was to restructure, reorganize, and reform state government to make it more responsive to the needs of its citizens and its business community. One recommendation included in the CPR report issued in August 2004 was to expand strategic sourcing opportunities. The CPR report characterizes strategic sourcing as a rigorous, systematic process by which the organization analyzes its expenditures, evaluates internal and external influences, and determines the appropriate supplier relationships necessary to support overall organizational goals. The CPR report further states that strategic sourcing attempts to determine the total cost of a particular action before making a decision to purchase a good or service rather than making a decision based solely on purchase price.

In June 2004, before the release of the CPR report, General Services awarded a three-year contract to CGI-American Management Systems (CGI) to assist it in implementing its strategic sourcing initiative. CGI was to analyze the goods and services commonly purchased by state agencies and to identify categories of goods and

services to strategically source to achieve cost savings. According to the June 2004 governor's announcement of the contract being awarded, the State was spending more than \$4 billion annually on goods and services. The announcement stated that by consolidating purchasing power in one entity, the State may reduce its costs by up to 15 percent each year for purchases of various products.

CGI's methodology for strategic sourcing a particular category included data gathering, projecting purchases and savings, and tracking savings. After accomplishing its initial strategic sourcing efforts through the help of CGI, General Services reorganized its Procurement Division in November 2006 to create the Intake and Analysis Unit (IAU). One of the IAU's duties is to gather purchasing data to explore new strategic sourcing opportunities. At the time of our audit, the IAU had six and a half positions.

Small Business and Disabled Veteran Business Enterprise Participation Requirements

According to a governor's executive order issued in May 2001, all state agencies must pursue aggressively an annual 25 percent small business participation level in state contracting. The executive order also states that small businesses are the principal source of new jobs in California's economy and are instrumental to its health. In the interest of enhancing opportunities for small business to participate in the state contracting process, the governor set a goal for all state agencies to award at least 25 percent of their contract dollars to small businesses. A more recent executive order issued in March 2006 reaffirms the goal and notes that California's sustained economic prosperity is tied directly to the success of its small businesses because they represent 98 percent of California enterprises and employ more than 50 percent of the workforce.

Further, state law requires state agencies, when awarding a contract to the lowest bidder or to the bidder with the highest score when factors in addition to price are considered, to give a 5 percent preference to California small business bidders meeting specifications. The 5 percent preference is based on either the lowest cost or the highest scored bid, depending on the bid solicitation method used. State regulations also require this preference to be applied to a bidder other than a small business that commits to use small business subcontractors for at least 25 percent of its net bid price. In requiring the 5 percent preference, the Legislature declared that providing opportunity for full participation by small business enterprises is essential and that the State should assist and protect the interests of small businesses to

ensure that a fair proportion of the total purchases and contracts or subcontracts for property and services for the State be placed with such enterprises.

Further, state law establishes a 3 percent Disabled Veteran Business Enterprise (DVBE) participation goal to recognize disabled veterans for their service and to further DVBE participation in state contracting. This goal applies to state agencies' overall annual expenditures for contracts. However, state agencies may decide to omit the DVBE goal from an individual solicitation, or alter the required participation level above or below 3 percent, so long as they meet the overall 3 percent goal for the year. To satisfy the participation level specified by a state agency for an individual solicitation, a bidder generally must commit to use DVBEs for not less than the specified percentage of the dollar amount of the bid. Before a change in the law that became effective July 2009, bidders could meet a DVBE participation 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. Additionally, 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. Similar to the small business preference, the incentive gives a qualifying bidder an advantage in the bid evaluation process, whether the bid is based on cost or other factors.

Scope and Methodology

The Joint Legislative Audit Committee (audit committee) requested that the Bureau of State Audits (bureau) review General Services' strategically sourced contracting practices and the effects these practices have on California small businesses and DVBEs. Specifically, the audit committee asked that we evaluate General Services' procedures for establishing strategically sourced contracts and determine how General Services ensures that small businesses and DVBEs are given an equitable opportunity to be chosen as strategically sourced contractors. We were asked to select a sample of strategically sourced contracts and determine if the justification for the contract met the applicable and established criteria; if General Services followed applicable laws, regulations, and policies and procedures when entering into contracts; and how General Services evaluated contractor compliance with laws

related to providing commercially useful functions.¹ The audit committee also requested that we evaluate General Services' policies and procedures to ensure compliance with contract terms of strategically sourced contracts.

If General Services tracks such information, the audit committee asked the bureau to calculate the ratio of strategically sourced contracts awarded to small businesses and DVBEs compared with all strategically sourced contracts. It further requested that we compare the number of small business and DVBE contracts for the two years before the implementation of strategic sourcing with the number of small business and DVBE contracts since General Services implemented strategic sourcing. The audit committee also asked us to compare the number of strategically sourced contracts during fiscal years 2007–08 and 2008–09 with all contracts entered into during the same period.

We also were asked to review and assess General Services' process for evaluating and estimating benefits to the State of strategically sourced contracts, as well as to determine whether General Services compares the ultimate cost savings of the strategically sourced contracts with preliminary estimates of cost savings from its analysis. Finally, the audit committee requested that we identify the changes in the number of staff in General Services' Procurement Division since the inception of the strategic sourcing initiative and determine the reasons for any increase in staffing.

To evaluate General Services' procedures for establishing strategically sourced contracts and to determine how it ensures that small businesses and DVBEs are given equitable opportunities to be chosen as strategically sourced contractors, we reviewed applicable laws, regulations, and policies and procedures. We also interviewed appropriate staff at General Services and reviewed relevant documentation to understand the changes in policies and procedures over time. We reviewed 14 contracts awarded between July 2006 and December 2009 to determine whether General Services followed its policies and procedures for assessing whether the contracts should be strategically sourced. We also reviewed the solicitation process for these contracts to determine whether General Services followed significant laws, regulations, and policies and procedures when entering into contracts. We reviewed the solicitations for seven of the 14 contracts that proposed the use of small businesses or DVBEs for a portion of the contract work and determined whether General Services appropriately awarded the small business and DVBE preferences and incentives. Further, we

¹ State law related to commercially useful functions focuses on ensuring that small businesses and DVBEs play a meaningful role in any contract in which they participate.

reviewed the solicitations for these contracts to determine how the bidders plan to use subcontractors to perform commercially useful functions. The oldest solicitation in our review was released before the implementation of General Services' current policy for obtaining bidders' declarations regarding these plans. For this solicitation, documentation indicated that General Services instead held nonmandatory, confidential discussions with interested bidders in an effort to ensure compliance with commercially useful function requirements.

To evaluate General Services' policies and procedures to ensure compliance with contract terms of strategically sourced contracts, we reviewed available policies and procedures and interviewed appropriate staff. We reviewed selected contracts that General Services has monitored for compliance with contract prices to determine whether it appropriately determined pricing compliance and promptly followed up with contractors regarding any discrepancies it identified.

To calculate the ratio of strategically sourced contracts awarded to small businesses and DVBEs compared with all strategically sourced contracts, we identified 33 strategically sourced contracts through our review of documents and discussions with various General Services' staff. We reviewed appropriate contracts and other documents to determine the small business and DVBE participation information for these contracts. We present information for these contracts using the number of small business and DVBE subcontractors to which each contractor, at the time of award, committed to provide business.

To compare the number of small business and DVBE contracts for the two years before the implementation of strategic sourcing with the number of such contracts since General Services implemented strategic sourcing, we requested contracts that General Services awarded during these periods and the related small business and DVBE participation. We focused our request on statewide goods contracts because those are the types of contracts that General Services subjected to strategic sourcing. However, General Services only began centrally tracking participation data for these contracts in fiscal year 2007-08. Consequently, we were unable to perform this step for contracts that General Services awarded. However, to determine any trends in small business and DVBE participation, we reviewed the annual reports to the Legislature that General Services is required to prepare that identify such participation on contracts awarded by state agencies. We reviewed the trend for five large state agencies and talked to two of them to determine whether there were any changes in participation related to strategic sourcing.

To compare the number of strategically sourced contracts during fiscal years 2007–08 and 2008–09 with all contracts entered into during the same periods, we asked General Services to provide a list of all contracts it awarded during these years, as well as those that were strategically sourced. However, although General Services performed certain analyses, it did not strategically source any contracts during fiscal years 2007–08 and 2008–09. As a result, we did not perform this comparison.

To assess General Services' process for evaluating and estimating benefits to the State of strategically sourced contracts and determining ultimate savings, we reviewed related policies and procedures. We also interviewed appropriate staff and compared General Services' current procedures with the procedures used by CGI. In addition, we reviewed the savings estimates that CGI developed for the 10 categories General Services implemented. We verified one month of savings calculations performed by CGI and General Services for the four largest categories in terms of savings. We also reviewed all invoices submitted by CGI to determine whether General Services verified invoice amounts.

Finally, to identify the changes in the number of staff in General Services' Procurement Division since the inception of the strategic sourcing initiative and determine the reasons for any increase in staffing, we reviewed state budget documents and interviewed appropriate staff.

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Audit Results

A Consulting Firm Assisted the Department of General Services in Implementing the Strategic Sourcing Initiative

When implementing the strategic sourcing initiative, the Department of General Services (General Services) hired a consulting firm to identify the types of contracts to strategically source and to estimate the potential savings that could be realized. After the initial efforts, General Services planned to continue the strategic sourcing initiative using its own staff. To train its staff on the strategic sourcing process and to develop written procedures, General Services was again assisted by the consulting firm.

General Services awarded a contract in June 2004 to CGI-American Management Systems (CGI) to assist it in identifying and creating strategically sourced contracts in response to a recommendation of the California Performance Review, which we discuss in the Introduction. The contract required General Services to pay CGI 10.5 percent of the first \$400 million in accrued savings realized through strategically sourced contracts until June 2007, when the CGI contract expired.² The purpose of strategically sourcing contracts was to leverage the State's purchasing power to save money on goods and services that state agencies purchased most frequently. To identify this information, CGI collected expenditure data for broad spending categories through analysis of accounts payable data from state agencies.

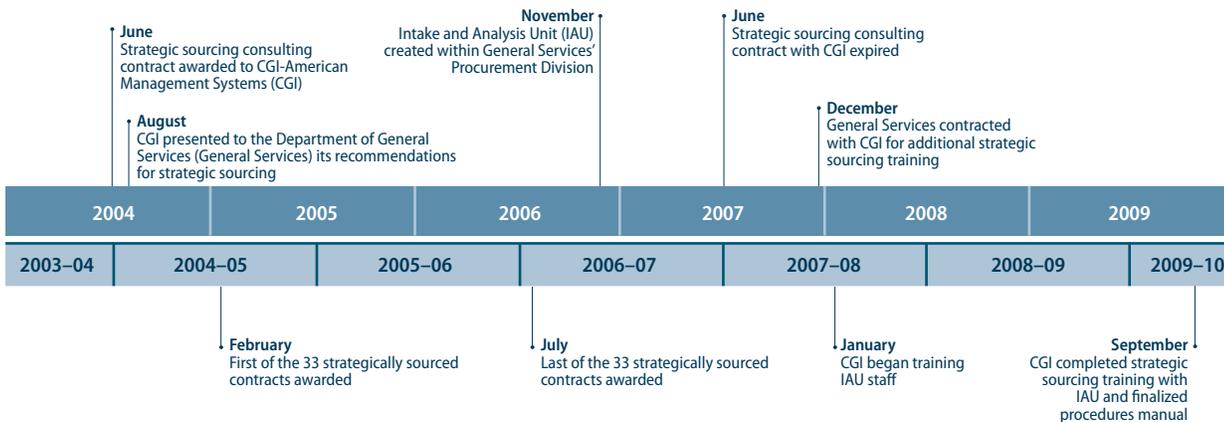
CGI estimated the amount of savings the State could attain in each spending category, based on a proprietary historical database of actual savings other entities had achieved through similar efforts. The historical data yielded a range of savings possible in a category. Using the savings estimates, CGI identified categories as Wave 1 or Wave 2. It selected Wave 1 categories, which were to be pursued first, based on the savings potential and ease of implementation. Wave 2 categories were characterized as a combination of relatively straightforward but lower-benefit categories and several more complex categories. Based on CGI's analyses, General Services awarded a series of contracts in certain Wave 1 categories between February 2005 and July 2006. To achieve the savings for strategically sourced contracts, General Services established these contracts as mandatory for state agencies to use with certain exceptions.

² The fee schedule in the contract provided for differing fee percentages depending upon the level of savings achieved. For savings exceeding \$400 million, the percentage started at 9.75 percent and declined to 5 percent.

As Figure 2 shows, before its initial contract with CGI expired in June 2007, General Services created the Intake and Analysis Unit (IAU) within its Procurement Division. The IAU was to act as a “front door” to the Procurement Division through which all work for the division would be tracked. As part of this role, the IAU was responsible for reviewing new contract requests from state agencies and the State’s contract expenditure patterns to identify new strategic sourcing opportunities. However, General Services found subsequent efforts to continue strategically sourcing contracts to be difficult. Although the contract with CGI provided for certain training, General Services determined that additional training was necessary because of the almost complete turnover in staff who participated in the initial effort. It again contracted with CGI in December 2007 for an eventual cost of about \$1 million—this time to train IAU staff on the strategic sourcing process and to develop a strategic sourcing manual. The contract also required CGI to train staff and provide technical support on its price compliance system, discussed later in the report. The training and procedures manual were completed in September 2009.

Figure 2

**Timeline of Events Related to the Department of General Services’ Strategic Sourcing Efforts
Fiscal Years 2003–04 Through 2009–10**



Sources: Documents obtained from General Services’ IAU.

The procedures manual is a step-by-step guide to apply strategic sourcing methods to identify new sourcing opportunities and to design a procurement process to achieve the most savings. This process begins when the IAU performs an opportunity assessment, a high-level assessment to identify potential categories that can be strategically sourced. If the assessment identifies such an opportunity, General Services’ procedures call for the IAU to perform a full sourcing effort, which includes analyses of the

State's usage of the goods or services, the market structure, and the development of an estimate of potential savings. The steps involved are similar to the ones used by CGI in identifying strategic sourcing opportunities. According to the procedures manual, the IAU is to perform opportunity assessments for statewide and one-time acquisition contracts.

However, IAU staff informed us that they do not currently perform such assessments for individual one-time acquisition contracts because they do not know how much of the similar goods other state agencies purchase through their delegated purchase authority. IAU staff stated that instead they periodically review summary information on one-time acquisitions to determine how often such contracts are requested and whether a statewide contract for such items should be considered. Additionally, IAU staff perform opportunity assessments for statewide contracts only for goods and not for services.

In February 2010 IAU staff provided information that indicated it has awarded 17 statewide goods contracts since September 2009. However, General Services does not centrally track information on statewide contracts. It satisfied our request for a list of statewide goods contracts by providing a spreadsheet compiled from a number of other spreadsheets maintained by several different units. Thus, we are unable to verify the completeness of this information. Our review of four such statewide goods contracts that General Services awarded since September 2009 found that although the IAU performed opportunity assessments as required for these contracts, it did not recommend strategically sourcing them. In one instance, the IAU recommended extending the previous contract for the category because its analysis showed the State was experiencing significant savings when compared to other states, but ultimately a new solicitation was issued, in part because of ongoing performance issues with the contractor. For the three remaining contracts, the nature of the goods being purchased affected the IAU's recommendation. For example, two contracts were for vehicles, which the IAU supervisor stated are not considered for sourcing because vehicle specifications, and thus departmental needs, change annually.

General Services' Initial Strategic Sourcing Efforts Resulted in Significant Savings

General Services' documents indicate that the State realized at least \$160 million in net savings through June 2007 as a result of the initial strategic sourcing efforts with the help of CGI. Those savings exceeded the estimates for eight of the 10 categories implemented. General Services paid CGI a portion of the savings gained under

In our review of four of 17 statewide goods contracts that General Services awarded, we found that the IAU performed opportunity assessments but did not recommend strategically sourcing them.

the contracts, and the State continued to use strategically sourced contracts after CGI's contract expired. After the end of CGI's contract, however, General Services changed the way it tracked savings, and as a result the total amount of savings, estimated by General Services to be substantial, is unknown.

Based on CGI's recommendations for Wave 1, General Services awarded 33 strategically sourced contracts for 10 categories of goods. In making its recommendations, CGI estimated the annual savings the State could achieve for these 10 categories. It computed the estimated annual savings by determining the historical purchase prices for various goods within each category and comparing them with the discounted market prices it determined the State could achieve. For example, in the office equipment category, which includes copy machines, CGI believed based on its analysis that the State could reduce annual costs by 15 percent to 25 percent through strategic sourcing. CGI noted that the State spent about \$13 million per year on office equipment category expenditures that could be reduced through strategic sourcing, which implied an annual savings of \$2 million to \$3.3 million. In all, the 10 categories comprised \$532.8 million in historical annual purchases, and CGI estimated the annual savings to the State to be \$39.5 million to \$65.8 million, assuming the same volume of purchases.

CGI—the firm contracted to assist in implementing the strategic sourcing initiative—received 10.5 percent of the accrued savings to the State from the 33 strategically sourced contracts through June 2007.

General Services' contract with CGI required that payment to CGI be based on accrued savings realized by the State for strategically sourced contracts. Specifically, CGI received 10.5 percent of the accrued savings to the State from the 33 strategically sourced contracts through June 2007. CGI periodically computed the savings the State realized for each of the 10 categories General Services strategically sourced and invoiced it for 10.5 percent of the savings for each category. We found that General Services appropriately reviewed and validated the savings CGI computed to support 189 invoices before approving payments.

To compute accrued savings, 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. CGI 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, a percentage of which CGI was paid. Thus, to the extent that the State actually paid contract prices, accrued savings equaled actual savings. Strategically sourced contracts establish the maximum that a contractor may charge the State; however, state agencies can negotiate lower prices when placing orders with a contractor. Because the calculation of accrued savings was based on contract prices, CGI would not share

in any additional savings the State realized if it paid prices lower than those called for in the contract. Similarly, the calculation of accrued savings, and thus the amount paid to CGI, would not be reduced for any instances in which the State paid more than stated in the contract and thus achieved lower savings than it should have. Structuring CGI's payment terms in this way reflects the fact that it was the State's responsibility to ensure that it did not pay contractors more than it was contractually obligated. However, as we discuss later in the report, General Services did not have a routine process to monitor contractors' compliance with pricing terms until August 2008, when it began implementing its current automated process.

Our review of one month's savings calculations for the four categories with the largest savings found that CGI's computed accrued savings were accurate. We further calculated the actual savings using the prices the State paid for the purchases and found that the actual savings were higher for three of the categories. However, as indicated previously, in these instances CGI would be paid based only on the accrued savings. Only in one category was the actual savings less than accrued savings, and that was by 0.4 percent. General Services hired KPMG Consulting (KPMG) in 2005 to perform a category-by-category audit of the accuracy of the CGI-established historical cost analysis and identify any recommendations for correction of audit findings. When assessing the accuracy of CGI's computed savings, we relied on the work performed by KPMG and used CGI-developed historical prices.

The savings calculations indicated that between February 2005 and June 2007, the State incurred \$179 million less in costs for purchases under the strategic sourcing contracts. Based on its validation of the savings calculated by CGI, General Services paid CGI fees of \$18.8 million. In addition, General Services paid \$257,000 to KPMG to validate CGI's methodology for estimating initial savings to the State, including reviewing the data used to determine the historical prices the State paid for various goods and services. Therefore, General Services' documents indicate that the net accrued savings realized by the State from the strategic sourcing contracts through June 2007 was \$160 million.

As Table 1 on the following page shows, the State's savings exceeded the amount estimated by CGI for most categories. In the information technology hardware-enterprise category, for example, the average annual accrued savings to the State was \$21 million, whereas the estimated annual savings for this category projected by CGI was \$5.8 million to \$7.8 million.

After General Services paid CGI fees of \$18.8 million and \$257,000 to KPMG to validate CGI's methodology, the net accrued savings realized by the State from strategic sourcing contracts through June 2007 was \$160 million.

Table 1
The Projected and Accrued Savings for 10 Categories of Goods That the Department of General Services Strategically Sourced
(In Millions)

CATEGORY	PROJECTED ANNUAL SAVINGS*	AVERAGE ANNUAL ACCRUED SAVINGS†
Information technology hardware—personal computer goods	\$22.4	\$33.2
Proprietary pharmaceuticals‡	11.0	1.0
Information technology hardware—enterprise	7.8	21.0
Wireless equipment and services	7.7	11.2
Medical prime vendor (pharmaceuticals)§	4.0	5.2
Office supplies	4.0	4.3
Office equipment	3.3	12.6
Maintenance, repair, and operations	2.6	3.8
Pharmacy benefits management#	2.0	4.2
Vehicles	1.0	0.1
Totals	\$65.8	\$96.6

Sources: CGI-American Management Systems' (CGI) estimates of projected savings and CGI's calculations of accrued savings as verified by the Department of General Services (General Services).

* CGI developed a range of savings estimates upon which General Services based its decision to strategically source contracts. We present the high estimates that CGI developed for the various categories. However, once savings began to be realized, CGI continued to revise these estimates for the various categories throughout its involvement.

† General Services calculated the savings through June 30, 2007. Based on when a contract was awarded, these savings were realized over differing periods of time. For comparison purposes, we computed the average annual savings for the various categories.

‡ The proprietary pharmaceuticals category is comprised of pharmaceuticals without generic equivalents, the prices for which are established through contracts with others, including with the pharmaceutical manufacturers and the pharmaceutical wholesaler. These pharmaceuticals are distributed to the State by the pharmaceutical wholesaler under the medical prime vendor (pharmaceuticals) category.

§ The medical prime vendor (pharmaceuticals) category is comprised of generic, over-the-counter, and proprietary pharmaceuticals. The contract under this category is with a pharmaceutical wholesaler from which the State makes its purchases for state entities such as prisons, correctional youth facilities, mental health facilities, developmental centers, and universities.

|| The maintenance, repair, and operations category is comprised of janitorial, electrical, tools, safety, and industrial supplies.

The pharmacy benefits management category covers the State's adult parolee population receiving state-supported pharmaceuticals for mental health treatment.

In only two categories—vehicles and proprietary pharmaceuticals—did the accrued savings fail to meet the amount estimated by CGI. The vehicles category accounted for annualized savings of \$100,000, while the initial estimates for this category had been \$600,000 to \$1 million per year. Proprietary pharmaceuticals resulted in about \$1 million in average annual savings against an estimate of \$4 million to \$11 million per year. According to the supervisor of the IAU, only one of the six proprietary pharmaceuticals subcategories, Hepatitis-C, was actually awarded due to the complexities involved in negotiating contracts with pharmaceutical manufacturers. We also inquired about subsequent efforts to award contracts

in these areas. The pharmaceutical program manager within the Procurement Division stated that it was not able to negotiate contracts with manufacturers for one subcategory and it chose not to pursue two other subcategories because cheaper generic brands became available or because of the diversity of drugs within the subcategory combined with limited purchases. The manager noted that in two other subcategories the Department of Corrections and Rehabilitation accounted for the most purchases. However, the federal court-appointed receiver who took over the provision of medical services to inmates is exempt from the State's contracting rules, based on a waiver granted by the federal court, and does not participate in these types of contracts through General Services. This diminished the available savings opportunities in the proprietary pharmaceuticals category.

The terms of the 33 strategically sourced contracts extended beyond June 2007; thus, the State continued to benefit from savings under the contracts. However, General Services no longer formally calculated the savings after June 2007 when it no longer used them to determine the amount to be paid to CGI. Instead, it provided us with approximate savings it computed for purchases between July 2007 and February 2010 by applying a fixed percentage to purchases under these contracts. It determined the percentage based on the savings it realized on the categories up to June 2007. In effect, application of the category-wide savings percentage is based on the unlikely assumption that state agencies purchased products from July 2007 to February 2010 in a pattern for each category that was identical to that from the date each contract was awarded through June 2007. As a result, General Services' calculation of savings from July 2007 to February 2010 is only a rough estimate.

Further, 28 of the original 33 contracts have expired, and the remaining five are scheduled to expire by July 2010. Although General Services has rebid or extended 26 of the 28 contracts that have expired, its Procurement Division management acknowledges that the historical information used by CGI in recommending strategically sourcing various goods and services and measuring related savings may no longer be relevant because that information was based on purchases during fiscal years 2002-03 and 2003-04.³ As a result, General Services would need to examine the State's recent purchasing patterns to determine the expected future savings for the various items.

Because the federal court-appointed receiver is exempt from state contracting rules and does not participate in these types of contracts through General Services, the available savings opportunities in the proprietary pharmaceuticals category were diminished.

³ In response to our inquiries during the audit, we received replies that reflected the collective views of the deputy director of the Procurement Division and the chief of the Strategic Sourcing and Acquisitions Branch. The chief of the Acquisitions and Contract Management section also participated in many of the responses. We collectively refer to them as Procurement Division management throughout our report.

General Services Has Not Entered Into New Strategically Sourced Contracts

General Services has strategically sourced no new contracts, even though it has created a unit that is tasked with, among other duties, identifying additional strategic sourcing opportunities and even though it paid for training and a procedures manual to do so. General Services indicates that the strategic sourcing method used by CGI is very resource-intensive; therefore, it has chosen to use traditional methods to award contracts it believes have achieved benefits similar in significance to strategic sourcing. However, it has not determined whether these contracts have achieved the same level of benefits as they could have using strategic sourcing. Considering the savings it realized for the 10 categories recommended by CGI that it implemented, General Services has not demonstrated that it has achieved the maximum possible savings. Further, it is not reviewing comprehensive purchasing data that would allow it to identify new opportunities effectively.

In addition to the 10 categories for which General Services originally awarded strategically sourced contracts, CGI had identified an additional six Wave 1 categories and 14 Wave 2 categories as good candidates for strategic sourcing. As Table 2 shows, CGI estimated that these additional categories, including telecommunications, architectural and engineering services, leased real property, and personnel services, could result in at least \$193 million in annual savings.

According to CGI's final report, General Services did not pursue the additional six Wave 1 categories because of timing, agency reorganization, or conflict of interest. The report did not provide further explanation, and General Services could not elaborate on what CGI meant in its report. It noted that General Services did not pursue the 14 Wave 2 categories because of the timing of the contract with CGI and the length of time it would take to award strategically sourced contracts for these categories. Further, the report noted that General Services was not primarily responsible for procuring many of these categories. The report acknowledged that, nevertheless, General Services could work with the controlling state agencies to apply strategic sourcing methods to these categories.

CGI noted that General Services did not pursue certain categories because of the timing of the contract with CGI and the length of time it would take to award strategically sourced contracts for these categories.

When we inquired about strategic sourcing efforts after CGI's contract ended, we learned that although its IAU performs opportunity assessments for statewide contracts, General Services has not awarded any new contracts using the strategic sourcing procedures it developed. Further, when we looked into General Services' specific progress on CGI's recommendations, we found that it had not prepared any kind of comprehensive analysis

Table 2
Annual Savings for Recommended Categories Not Strategically Sourced
as Estimated by CGI-American Management Systems

CATEGORY*	ESTIMATED ANNUAL SAVINGS (IN MILLIONS)
Wave 1	
Leased real property	\$50
Telecommunications	30
Pharmaceutical benefits management for state employees	25
Hospital services	12
Temporary staffing	6
Medical prime vendor (medical supplies)	1
Subtotal	\$124
Wave 2	
Architectural and engineering services	\$>20
Hotel	10
Other professional services	6
Personnel services	5
Capital purchases	4
Commercial airline	4
Food and beverage	4
Natural gas	4
Waste services	4
Rental car	3
Facilities services	2
Printed materials	2
Travel agency	<1
Electricity	Unspecified [†]
Subtotal	\$69
Total	\$193

Source: Closeout report dated March 2008 prepared by CGI-American Management Systems (CGI) and submitted to the Department of General Services (General Services).

* Although General Services did not strategically source these categories, it noted it has awarded contracts through traditional methods to address many of these categories. It also indicated that in certain instances other state agencies have awarded contracts. However, it has not determined whether these contracts have achieved the same level of benefits that they could have using strategic sourcing. We discuss this matter further in the text.

† CGI did not estimate savings for the electricity category but noted that this category had as much as \$600 million that could be strategically sourced.

documenting its attempts to strategically source the additional categories or its rationale for not strategically sourcing. Instead, in response to our inquiries, Procurement Division management researched the matter and prepared a schedule for us that indicated that General Services has awarded various contracts to address many of the categories recommended by CGI. Management noted that General Services has developed statewide contracts for some categories, including personnel services and other professional

services. However, none of these contracts were based on analyses prepared by the IAU, which is responsible for strategic sourcing efforts. Management stated that contracts for some categories were awarded by other state entities. For example, they noted that the California Prison Health Care Services, under the oversight of the federal court-appointed receiver, awarded contracts for the hospital services category, for which CGI estimated \$12 million in potential annual savings.

We inquired about the reasons that certain large categories were not implemented through statewide contracts. For instance, Procurement Division management noted that General Services could not implement the leased real property category through strategic sourcing because it is not a standardized good that can be categorized or bid in lots for statewide use. Additionally, they stated that General Services could not strategically source the architectural and engineering services category. Management pointed to state law, which requires that architectural and engineering services contracts be awarded on the basis of demonstrated competence and professional qualifications related to the services required. Such contracts must be awarded based on a contractor's ability to perform the specific services required, so a change in state law may be required for General Services to include all architectural and engineering services in a statewide contract. These two categories presented as examples represent \$70 million of the \$193 million in annual savings CGI estimated.

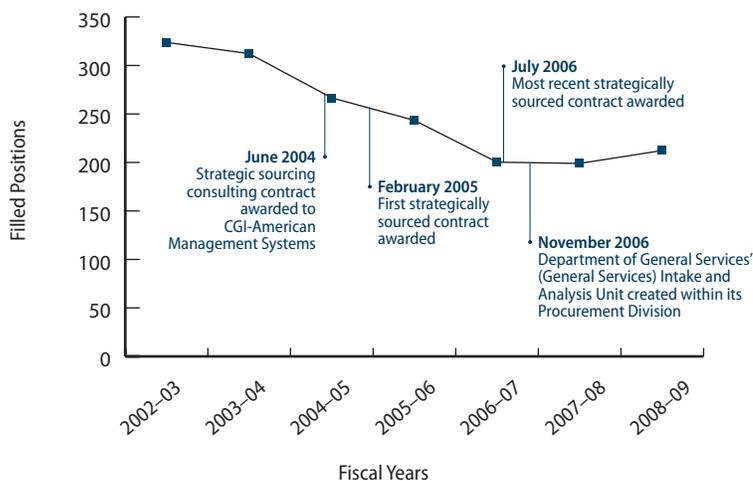
Procurement Division management stated General Services issued statewide contracts for many of the remaining categories identified by CGI. However, when we queried staff responsible for the contracts issued for three of these categories, they indicated that the process of awarding these contracts was not affected as a result of being identified as a potential strategic sourcing category and were awarded using traditional processes. Additionally, its supervisor noted that the IAU, which was created in 2006 to, among other duties, identify strategic sourcing opportunities, was not involved with any of the outstanding Wave 1 and Wave 2 categories. Further, General Services has not determined whether these other contracting efforts resulted in savings equivalent to those possible through strategic sourcing. Nevertheless, although there may be categories that General Services could pursue among those recommended by CGI, the information that General Services recently provided suggests that the savings to be realized may be considerably less than the \$193 million once estimated. Procurement Division management told us they will again review the categories under their purview to determine if there are further opportunities to achieve savings through fully strategically sourcing a solicitation or through another contracting method.

Although there may be categories that General Services could pursue, the information that General Services recently provided suggests that the savings to be realized may be considerably less than estimated.

In addition to ensuring that it maximizes whatever savings are available in the categories that CGI recommended, General Services should consider new strategic sourcing opportunities. CGI's analysis was based on fiscal years 2002–03 and 2003–04 purchasing data, and a detailed review of the State's purchasing patterns has not occurred since then. The current purchasing landscape may be significantly different than what existed seven and eight years ago. In fact, General Services acknowledges that the data reviewed by CGI may not be relevant for current conditions. Analysis of current statewide data could yield additional strategic sourcing opportunities.

Procurement Division management noted that to replicate a full, stringent, strategic sourcing effort like that performed by CGI, General Services would need to obtain access to individual purchase orders, invoices, and accounts payable data. Management stated that this would be a considerable undertaking because the State has neither a single accounts payable or purchasing system nor the resources or technology to compile the data manually. As part of our review, we looked at the staffing level within the Procurement Division over time. As Figure 3 shows, the staffing level generally has decreased since 2004, when General Services awarded a contract to CGI and first undertook strategic sourcing efforts.

Figure 3
Changes in Staffing Level Within the Department of
General Services' Procurement Division



Sources: Staffing information from the Department of Finance's annual salaries and wages supplements. Other information provided by General Services.

Although its initial efforts resulted in significant savings to the State, General Services has not sought additional resources to continue these efforts to identify new opportunities. Procurement Division management stated that although strategic sourcing has yielded significant results, General Services has achieved similar benefits through the use of more traditional, less resource-intensive methods. Management believes they have struck an appropriate balance between providing resources to the statewide contracting and strategic sourcing effort and the many other programs General Services operates within the current fiscal environment. However, General Services has not determined whether its traditional methods have resulted in the maximum savings possible through strategic sourcing. Further, it is not reviewing comprehensive purchasing data that would allow it to effectively identify new opportunities. Instead, when it performs opportunity assessments to determine if strategic sourcing is warranted, General Services primarily considers the usage information it receives for existing statewide contracts. It is not considering other purchases made by state agencies. Although General Services may be correct that performing the level of analyses that CGI performed is resource-intensive, the cost involved may be justified considering the savings it achieved through its initial efforts.

Although General Services plans to use its eProcurement system for strategic sourcing purposes, we had previously noted that a component of the system contained incomplete and inaccurate information.

Procurement Division management noted that it plans to use its eProcurement system for strategic sourcing purposes. The eProcurement system includes the State Contracting and Procurement Registration System (SCPRS). SCPRS is an online database that state agencies use to input information related to purchasing documents, such as contracts, that exceed \$5,000. However, the data in SCPRS is only as reliable as the information entered by each agency. For example, our 2009 audit of two state agencies' information technology contracting practices showed that agencies did not always adhere to requirements for reporting contracts in SCPRS.⁴ Thus, SCPRS contained incomplete and inaccurate information. Further, line items in SCPRS are for a particular contract rather than the individual types of products purchased under that contract. Therefore, SCPRS does not provide the level of detail that General Services would need to identify the specific items state agencies are purchasing. However, management states that SCPRS, although not perfect, will give General Services an estimated valuation of expenditures by category to consider.

⁴ *Departments of Health Care Services and Public Health: Their Actions Reveal Flaws in the State's Oversight of the California Constitution's Implied Civil Service Mandate and in the Departments' Contracting for Information Technology Services*, Report 2009-103, September 2009 (report by the Bureau of State Audits).

Procurement Division management noted that they do not require state agencies to enter transactions into SCPRS at a line item level due to the increased workload associated with the additional data entry, given the current fiscal environment. They did indicate that the eProcurement system may include line item data in the future. Specifically, management stated that General Services is currently implementing a new subcomponent of SCPRS that will yield line item data for purchases made by state agencies through statewide contracts using eProcurement. Additionally, they noted that General Services plans to implement functionality within the eProcurement system that would allow integration with state agencies that have enterprise-wide systems to upload their purchasing data into eProcurement. Management also noted that four state agencies are adopting this functionality as part of a pilot project, and 52 other agencies have expressed an interest in these new capabilities. However, management noted that such functionality is available only to agencies with an enterprise-wide system in place, and the data uploaded would be limited to the level of detail the agencies maintain in their enterprise-wide systems. Management's comments indicate that, 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.

The 33 strategically sourced contracts, and the savings that were realized as a result of their implementation, were established after the collection, compilation, and analysis of detailed purchasing data. This level of detail is necessary to determine the type and quantity of goods state agencies are purchasing, which would allow General Services to assess the benefits of leveraging these purchases. Without such data, General Services may be overlooking new opportunities to significantly leverage the State's buying power.

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

In an effort to increase small business and Disabled Veteran Business Enterprise (DVBE) participation, state law and regulations require that agencies that award contracts provide preferences and incentives to these firms. General Services recognized that strategic sourcing could affect state agencies' ability to reach small business and DVBE participation goals; for these contracts it provides state agencies with the alternative of contracting directly with small businesses and DVBEs in order to mitigate this effect. This alternative is referred to as an "off ramp." General Services does

Without detailed purchasing data to determine the type and quantity of goods state agencies are purchasing, General Services may be overlooking new opportunities to significantly leverage the State's buying power.

not know how often state agencies use the off ramp, however, so it cannot evaluate its effectiveness in providing opportunities for small business and DVBE participation.

General Services Typically Follows State Laws and Regulations in Awarding Bids

Designed to promote competition, state law requires, except in cases of emergency, that General Services advertise contracts for goods exceeding \$25,000 in the California State Contracts Register. In addition, state law and regulations require that General Services provide for small business preferences and use DVBE incentives when awarding state contracts. Our review of 14 solicitations for contracts between 2006 and 2009, including one solicitation that resulted in four strategically sourced contracts and one rebid of a strategically sourced contract, found that General Services generally evaluates and awards bids in compliance with state laws and regulations governing competition and awarding of preferences and incentives.⁵

General Services satisfied competition requirements for all 14 solicitations by advertising in the California State Contracts Register. It appropriately awarded preference points and incentives for six of the seven solicitations for contracts with small business or DVBE participation. Although in one case it applied a DVBE incentive in excess of the maximum that state regulations allow, this situation did not adversely affect the results, and the contract still was awarded to the appropriate bidder. The incentive, which varies based on the DVBE participation, gives a qualifying bidder an advantage in the bid evaluation process. At the time of the solicitation, the responsible contract administrator was not aware of a new regulation that established an incentive range of 1 percent to 5 percent. Before this regulation, General Services applied an incentive range of 3 percent to 10 percent, according to its policy.

General Services takes additional steps to ensure that small businesses and DVBEs have an equitable opportunity to participate in state contracts. By law the Office of Small Business and DVBE Services (Office) within General Services must aid small businesses and DVBEs in contracting with the State. The Office scheduled nearly 200 outreach events and workshops in fiscal year 2009–10, many of which the chief of the Office indicated were to teach small businesses and DVBEs how to effectively locate and compete for state contracting opportunities. The chief also stated that the Office

General Services scheduled nearly 200 outreach events and workshops in fiscal year 2009–10, many of which were to teach small businesses and DVBEs how to effectively locate and compete for state contracting opportunities.

⁵ Because General Services has not awarded any strategically sourced contracts since July 2006 and we focused on General Services' more recent evaluation and award process, the 14 solicitations included only one solicitation that resulted in four strategically sourced contracts and one rebid of a strategically sourced contract.

assists small business and DVBE firms in the certification process, guiding them in the effective use of descriptive key words and business classification codes to increase their chances of connecting with large prime vendors. The Office maintains the online list of small businesses and DVBEs that prime suppliers may use to search for potential subcontractors. Additionally, General Services may decide, as a part of a bidders' conference, to host a networking workshop to foster partnering opportunities between prime suppliers and prospective small business and DVBE subcontractors. We noted that General Services held such workshops for the solicitation that resulted in four strategically sourced contracts and the rebid of a strategically sourced contract we reviewed.

To ensure that General Services consistently meets its annual small business and DVBE goals, it enacted a policy in May 2009 requiring that all its procurements of less than \$100,000 for goods and services be awarded to small business, nonprofit veterans' service agency, or DVBE firms. As of January 1, 2010, the threshold increased to \$250,000. However, the policy allows its contract administrators to seek approval from the Office for a waiver of this requirement in instances in which it may not be feasible to contract with a certified small business or DVBE. Finally, a state agency that has not met the annual participation goals must submit an improvement plan to the Office. The Office chief stated that it then meets with the state agency's management and contract staff to ensure that the plan meets with a successful outcome.

To meet their small business and DVBE participation goals, state agencies can contract with a small business or DVBE for goods that the agencies otherwise would be obligated to purchase from a mandatory statewide contract that was strategically sourced. Strategic sourcing can result in mandatory contracts with large vendors and thus limit state agencies' avenues for attaining their participation goals, so General Services inserts a clause in strategically sourced contracts to allow agencies the option to forgo purchasing from the mandatory vendor and to contract with small businesses and DVBEs directly. General Services also applies the off ramp to some other mandatory statewide contracts with the same purpose: to provide agencies with alternative means of achieving small business and DVBE participation goals.

However, General Services does 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. Nevertheless, General Services needs this information to evaluate the effectiveness of the off ramp in providing opportunities for small businesses and DVBEs to participate in contracts with state agencies, even though mandatory statewide contracts, such as strategically

Although General Services has taken various steps to help state agencies meet their small business and DVBE participation goals, it does not track information regarding how often state agencies have used alternative means of achieving their goals.

sourced contracts, exist. This evaluation also should consider how the off ramp might affect the monetary benefits that result from statewide contracts designed to leverage the State's purchasing power. We discuss this consideration further in the next subsection.

Strategically Sourced Contracts Present a Trade-Off Between Conflicting State Goals

Strategic sourcing achieves lower prices by consolidating state expenditures into fewer contracts and thus taking advantage of volume discounts. However, consolidating state contracts also can result in fewer contracting opportunities for small businesses and DVBEs. According to Procurement Division management, General Services recognizes this risk and fully considers the impact on small businesses and DVBEs before purchasing items. Management states that General Services attempts to fully mitigate any potential negative impact to the extent it is in the State's best interests. For example, they stated that General Services included small businesses and DVBE participation commitments in the great majority of the strategically sourced contracts.⁶ However, although this practice may preserve the total amount of state funds allocated to small businesses and DVBEs, strategic sourcing still reduces the total number of businesses that participate in state contracts. Further, although Procurement Division management note that small business and DVBE participation has increased overall since the advent of strategic sourcing, they acknowledge that General Services does not track the effect an individual type of acquisition methodology, such as strategic sourcing, has on contracting with small businesses and DVBEs.

We attempted to determine the extent to which the numbers of small businesses and DVBEs within a particular category of goods were affected by strategic sourcing. A strategically sourced contract replaces the existing contracts entered into by state agencies. To determine any change in small business and DVBE participation, General Services would need participation data, including the number of small businesses and DVBEs participating in state contracts, for these contracts both before and after it strategically sources the goods. However, General Services currently has only some of the small business and DVBE participation data necessary to measure the impact of strategic sourcing.

Table 3 shows participation data for the 33 strategically sourced contracts. We compiled this table based on the number of subcontracted small businesses and DVBEs to which each

General Services currently has only some of the small business and DVBE participation data necessary to measure the impact of strategic sourcing.

⁶ As shown in Table 3, our review found that 22 of the 33 strategically sourced contracts contained commitments for either small business or DVBE participation.

contractor, at the time of contract award, committed to provide business. Further, General Services requires periodic reports that identify the amount of orders completed by the small businesses and DVBEs participating in the contracts. However, staff indicated that General Services does not have participation data showing the number of small businesses and DVBEs for contracts of categories of goods that subsequently were strategically sourced; nor does it have such data for contracts for related goods awarded by other state agencies through delegated authority using off ramps since the implementation of the strategic sourcing initiative. Without participation data for the contracts that have been consolidated into strategically sourced contracts, General Services cannot measure the impact of strategic sourcing on participation by small businesses and DVBEs. As a result, decision makers do not have adequate information to determine the true cost and benefit to the State of strategic sourcing.

Table 3
Number of Small Business and Disabled Veteran Business Enterprise Commitments for the 33 Strategically Sourced Contracts by the Department of General Services

CATEGORY	GOODS	CONTRACTOR	NUMBER OF SMALL BUSINESSES PARTICIPATING*	NUMBER OF DISABLED VETERAN BUSINESS ENTERPRISES PARTICIPATING*
Information technology hardware—enterprise	Storage, open	Northrop Grumman	3	1
	Storage, open	Verizon	3	2
	Storage, mainframe	Northrop Grumman	3	1
	Storage, mainframe	Verizon	3	2
	Network attached storage	Technology Integration Group	4	1
	Tape storage	Western Blue/Systems Technology Associates	5	2
	Storage area network	Northrop Grumman	3	1
	Servers, UNIX-based, Sun	GovStor, LLC	1	0
	Servers, UNIX-based, HP	Western Blue/Systems Technology Associates	5	2
	Servers, UNIX-based, HP	Science Applications International Corporation	0	0
	Servers, UNIX-based, IBM	IBM Corporation	0	0
Information technology hardware—personal computer	Desktops and workstations	Gateway Companies, Inc.	11	5
	Desktops and workstations	Hewlett-Packard/Insight/ Western Blue	4	2
	Notebooks	Gateway Companies, Inc.	11	5
	Notebooks	IBM Corporation	0	0
	Servers	Marketware Technologies, Inc.	6	2
	Servers	Technology Integration Group	2	0
	Printers	Hewlett-Packard/Insight/ Western Blue	4	2
	Monitors	Gateway Companies, Inc.	11	5
	Peripherals	Hewlett-Packard/Insight/ Western Blue	4	2

continued on next page . . .

CATEGORY	GOODS	CONTRACTOR	NUMBER OF SMALL BUSINESSES PARTICIPATING*	NUMBER OF DISABLED VETERAN BUSINESS ENTERPRISES PARTICIPATING*
Maintenance, repair, and operations	Industrial supplies	MSC Industrial Supply Company	4	3
	Janitorial and custodial supplies	Grainger Industrial Supply	6	4
	Safety supplies	Empire Safety and Supply	3	3
	Toilet tissue	American Tex-Chem	0	0
Medical prime vendor (pharmaceuticals)	Prime vendor	AmerisourceBergen Drug Corporation	0	0
Office equipment	Copiers, digital and associate services	Sharp Electronics Corporation	19	1
Office supplies	Office supplies	OfficeMax	Varies [†]	Varies [†]
Pharmaceutical benefits management	Benefits manager	HealthTrans	0	0
Proprietary pharmaceuticals	Hepatitis-C vaccine	Roche	0	0
Vehicles	2005 model police pursuit sedans	Coalinga Motors	0	0
	2005 model CHP Class E special service	Folsom Lake Ford	0	0
Wireless service and equipment	Wireless equipment and services	Sprint Nextel Corporation	0	0
	Wireless equipment and services	Verizon Wireless	0	0

Sources: Bidders' solicitation responses, Office of Small Business and DVBE Services certifications, contract user guides, information received from the Department of General Services (General Services) regarding pharmaceuticals contracts.

* Some contractors and subcontractors were awarded more than one contract. Further, some small businesses are also owned by disabled veterans and are certified Disabled Veteran Business Enterprises (DVBEs). Therefore, the sum of small businesses and DVBEs for contracts shown here are greater than the actual number of subcontractors on these contracts.

† An amendment to the revised OfficeMax contract required OfficeMax to offer products equaling up to 25 percent of the total spent on this contract to be from small businesses and DVBEs, but it did not require specific participants for either group. As a result, the number of small business and DVBE subcontractors varied throughout the contract. However, according to the reports that OfficeMax provided to General Services, it subcontracted with, at a maximum, seven small businesses and two DVBEs.

Data From Other Agencies Have Limited Usefulness in Determining the Impact of Strategic Sourcing

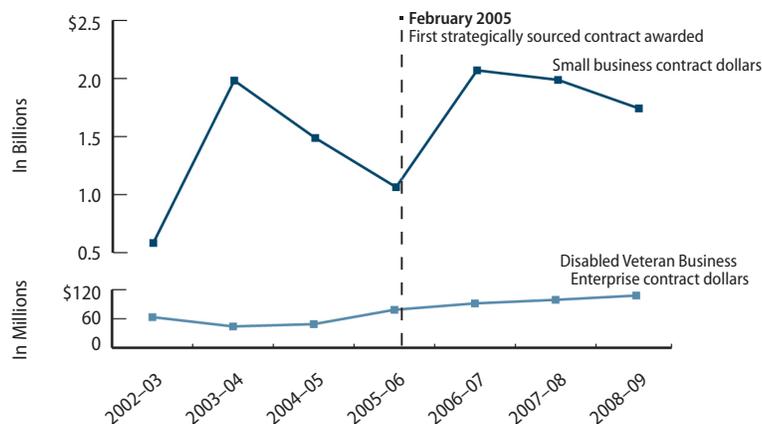
As we discuss in the Introduction, General Services has granted delegated purchasing authority to various state agencies, which allows them to purchase goods and services valued up to the predetermined threshold without approval from General Services. State agencies annually report participation data to General Services that include the total number and dollar amounts of contracts awarded to small businesses and DVBEs, and General Services uses this information to prepare a consolidated report, as required by state law. However, limitations largely hinder the use of these data in determining the impact of strategic sourcing.

Specifically, not all agencies have submitted a report every year, which makes it difficult to compare statewide data for various years. In light of this concern, we focused on five state agencies that were among the top five in awarding contract dollars in at least four of the seven years we reviewed: the California Public Employees' Retirement

System, the California Department of Corrections and Rehabilitation, General Services, the California Department of Transportation, and the Department of Water Resources.⁷ Of the agencies that reported between fiscal years 2002–03 and 2008–09, these five awarded 56 percent to 73 percent of the total contract dollars awarded statewide.

However, beginning in fiscal year 2005–06 the annual report began aggregating the data, reporting only the overall level of participation achieved across all services, construction, and goods contracts subject to the small business and DVBE participation requirements rather than reporting by individual contract types. Further, in no year does the annual report isolate participation levels for the subset of goods that CGI included in strategically sourced contracts. Nevertheless, this was the best information available, so we analyzed the data at the aggregate level. Figure 4 shows the dollar amounts awarded to small businesses and DVBEs as reported by the five large state agencies during the seven-year period. Figure 5 on the following page presents the reported number of contracts awarded by these agencies to small businesses and DVBEs.

Figure 4
Dollars Awarded to Small Businesses and Disabled Veteran Business Enterprises as Reported by Five Large State Agencies



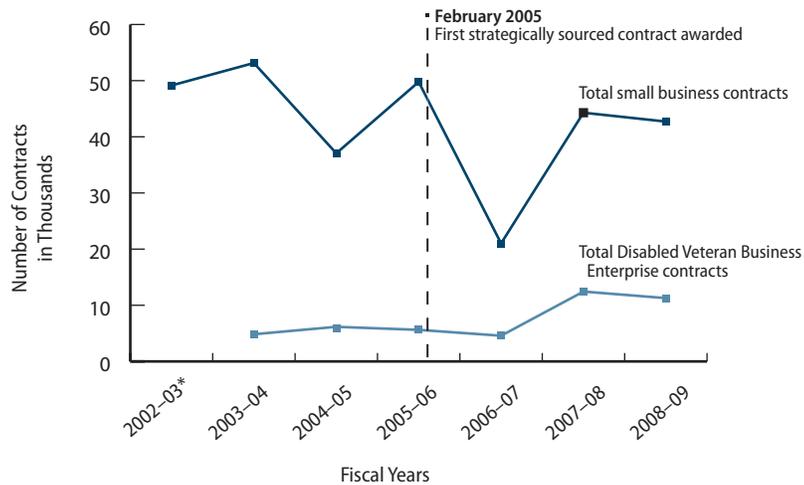
Source: The annual reports to the Legislature published by the Department of General Services.

Notes: The data shown are for all contracts, including services, construction, and goods.

For context, we also considered the trend for total contract dollars awarded by these five agencies. The total contract dollars awarded by these five state agencies continuously increased from \$3.3 billion in fiscal year 2002–03 to \$8.1 billion in fiscal year 2007–08, before decreasing to \$6.1 billion in fiscal year 2008–09.

⁷ The California State University system also reports a large amount of contract dollars but is not required to use strategically sourced contracts, and it reported only partial data in certain fiscal years; thus, it is not included in our analysis.

Figure 5
Number of Contracts Awarded to Small Businesses and
Disabled Veteran Business Enterprises as Reported by Five Large
State Agencies



Source: The annual reports to the Legislature published by the Department of General Services.

Notes: The data shown are for all contracts, including services, construction, and goods.

One of the five state agencies, the California Department of Corrections and Rehabilitation, informed us that during fiscal year 2006-07 it underreported the awarded number of small business contracts by 28,809 and the Disabled Veteran Business Enterprise (DVBE) contracts by 6,214. However, it noted that this did not affect the associated contract award dollars it reported.

* The fiscal year 2002-03 annual report to the Legislature did not include the numbers of DVBE contracts awarded by state agencies.

The data reported for the given state agencies indicates no clear negative impact on small business participation since the first strategically sourced contract was issued in February 2005. The reported small business participation, in terms of dollars awarded and number of contracts, fluctuated widely between fiscal year 2004-05, when the first strategic sourcing contracts were awarded, and fiscal year 2008-09 for the five large state agencies. Most notably, the reported number of small business contracts declined sharply from nearly 50,000 in fiscal year 2005-06 to slightly more than 21,000 in fiscal year 2006-07. However, the major driver of this large shift, the California Department of Corrections and Rehabilitation, which reported about a 24,000 decrease, explained to us that it underreported by nearly 29,000 the number of small business contracts it awarded in fiscal year 2006-07. Data inaccuracies such as this detract from the usefulness of this information.

Unlike small business participation, which has fluctuated since the first strategically sourced contract was awarded, the reported DVBE participation levels generally increased over the same period. For example, the California Department of Transportation reported awarding \$26.9 million in DVBE contract dollars through

1,358 contracts during fiscal year 2006–07 and \$54.2 million through 1,893 contracts in fiscal year 2008–09. It attributed the increase in DVBE contract awards to an initiative by its director to increase such participation. However, as with the small business participation data, the reported data related to DVBE participation also contain errors. The California Department of Corrections and Rehabilitation noted that it underreported by 6,214 the number of contracts awarded to DVBEs during fiscal year 2006–07. Although correcting for this error reinforces the upward trend in DVBE participation, it also highlights the inaccuracies in the reported information and the limitations in its usefulness to General Services in determining the impact that strategic sourcing has had on small business and DVBE participation.

General Services Does Not Monitor for Ongoing Commercially Useful Function Compliance

State law requires that small business and DVBE contractors and subcontractors participating in state contracts must provide a commercially useful function in furnishing services or goods that contributes to the fulfillment of the contract requirements. When awarding the contract, General Services relies on contractor declarations that the small business and DVBE subcontractors will perform activities that comply with these requirements. Although General Services might request clarification on the proposed role of these subcontractors, it does not verify the role they play once the contract is awarded.

The small business or DVBE must perform all activities identified in the text box. Further, the law explicitly states that a contractor or subcontractor will not be considered to perform a commercially useful function if it is limited to that of an extra participant through which funds are passed in order to obtain the appearance of small business or DVBE participation.

General Services requires bidders to identify in their bids the goods or services that each subcontractor will provide and the corresponding percentage of the total bid price that each will receive, and it relies upon their assertions to assess whether the subcontractors' roles will meet the commercially useful function requirements and determine overall eligibility for small business preferences and DVBE incentives. In order to gain the 5 percent small business preference, a bidder must be a certified small business itself or subcontract at least 25 percent of its net bid price

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.

Sources: Government Code, Section 14837, and Military and Veterans Code, Section 999.

to certified small businesses. For acquisitions that include the DVBE program requirement, bidders also receive an incentive that increases with the amount of DVBE participation they provide.⁸

General Services first verifies that each subcontractor that will perform some percentage of work is certified by its Office of Small Business and DVBE Services as a small business or DVBE. It then determines whether the work description for each subcontractor corresponds to a distinct element of work contained in the contract to be performed. Finally, it compares each subcontractor's responsibilities under the contract to the line of business described in its certification, and it reviews any implementation plan that bidders submit, following up as necessary. The bidder must list all subcontractors under the contract and indicate whether they are further subcontracting a portion of the work.

General Services does not verify the asserted functions that each subcontractor will serve. It may request that bidders clarify their plan for incorporating each subcontractor in a commercially useful way, but it ultimately relies upon this written plan and other bidder statements to assess intended compliance with the commercially useful function requirements. General Services also does not monitor small business and DVBE subcontractors to ensure that they comply with these requirements once the contract has been awarded. Instead, subcontractors receive a notification letter from General Services stating that they should expect to receive business from the contractor. The letter also instructs subcontractors to contact the contractor if they do not hear from the firm within a reasonable period of time.

Procurement Division management noted that contract administrators monitor the small business and DVBE statistics using reports from and meetings they have with contractors throughout the life of each contract. They stated that the Contracts Unit is currently enhancing its reporting features to include not only small business and DVBE participation levels on a monthly reporting basis but also to require the contractor to provide the payment date, check number, and the amount paid to subcontractors. Although these activities and reports would appear to help ensure that subcontractors receive payments, they do not necessarily address whether the small businesses and DVBEs perform commercially useful functions.

Although certain activities and reports would appear to help ensure that subcontractors receive payments, they do not address whether the small businesses and DVBEs perform commercially useful functions.

⁸ State regulations effective October 2007 require that whenever an awarding state agency applies the DVBE program requirement, it will offer an incentive that ranges from 1 percent to 5 percent. The regulations allow state agencies to provide incentive scales under which bidders obtaining higher levels of participation qualify for greater incentives.

Procurement Division management further stated that the individual state agency making the purchase is responsible for validating that subcontractors complied with commercially useful function requirements by obtaining from the contractors the necessary information that includes subcontractor name and dollar amount that can be claimed. Management pointed to a specific section in the *State Contracting Manual* as addressing the state agencies' responsibilities in this area. However, the *State Contracting Manual* section states only that state agencies can claim purchases toward their small business or DVBE goals whenever a contractor subcontracts a commercially useful function to a certified small business or DVBE. It also states that the contractor will provide the ordering state agency with the name of the certified small business or certified DVBE used and the dollar amount the ordering agency can apply toward its small business or DVBE goal. However, the *State Contracting Manual* does not provide specific guidance on how state agencies are expected to verify that small business and DVBE subcontractors actually performed commercially useful functions.

Additionally, we are concerned that other guidance instructs state agencies not to perform any ongoing monitoring of commercially useful function requirements. We noted that the user instructions in the contract for Office Depot, discussed further in the next section, stated that the certified small business and DVBE subcontractors had been assessed previously by General Services and determined to perform a commercially useful function. The user instructions went on to say that it was not necessary for state agencies to reverify or document information to this effect in the procurement file when executing transactions under the contract.

That General Services does not verify the intended functions of each subcontractor before the award of the contract is reasonable, as these intentions represent a plan that has not yet been enacted. However, if General Services believes that state agencies making purchases through statewide contracts should be responsible for monitoring the activities of subcontractors, it should provide guidance on how best to ensure that small business and DVBE subcontractors are performing commercially useful functions. In addition, we believe General Services should verify, for a sample of contracts, that the small business and DVBE subcontractors are performing commercially useful functions after the contracts are awarded. General Services could leverage its efforts by working with state agencies to determine whether small businesses or DVBEs that claim to have provided services did in fact provide the services for which the state agencies are being invoiced.

The State Contracting Manual does not provide specific guidance on how state agencies are expected to verify that such subcontractors actually performed commercially useful functions, and other guidance instructs agencies not to monitor for this requirement.

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

Questions have been raised regarding the roles of small business and DVBE subcontractors on the office supplies contract General Services awarded to Office Depot. Although General Services' internal audit found that the subcontractors met the requirements, the contract raises some policy questions that the Legislature may want to consider further.

As we note in the Appendix, 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. In its clarification of its initial proposal, Office Depot indicated that although the small businesses and DVBEs 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.⁹ In this case, Office Depot would act as a wholesaler to the small business and DVBE subcontractors. According to General Services, several small businesses have questioned whether these subcontractors complied with certain contract provisions, including commercially useful function requirements, which prompted it to request an internal audit. General Services' internal auditors noted that based on their review, the small business and DVBE subcontractors on this contract complied with such requirements.

In its 2008 audit of the Office Depot contract, the internal auditors confirmed that General Services employed its commercially useful function review process in evaluating the Office Depot bid, relying on certifications that qualify a business as a small business or DVBE and bidder documents and statements to make a determination for each subcontractor.¹⁰ Office Depot addressed commercially useful function requirements for each of its subcontractors by declaring in its bid that they would function as value-added resellers, performing distinct contract work elements such as invoicing, order acknowledgement, out-of-stock notification and remedy, returns and credit, and problem resolution services. The internal auditors also found that General Services' staff verified that the

⁹ In its initial proposal, Office Depot stated that the subcontractors would "actually take possession of the goods they resell." In a subsequent letter of clarification, Office Depot indicated that the subcontractors would purchase the merchandise from Office Depot at the wholesale price but would not take physical possession of the goods. Instead, Office Depot would handle all delivery logistics.

¹⁰ The contract's compliance with commercially useful function requirements is only one of the areas the internal auditors reviewed. We discuss other key findings of the internal audit in the Appendix.

proposed work was within each firm's line of business by reviewing the standard industrial classifications (classifications) that each subcontractor listed on its small business or DVBE certification.

Based on their visits to each of the nine small business and DVBE subcontractors and the firm that provided the online order system, interviews of General Services' Procurement Division and Office Depot staff, and review of relevant documentation, the internal auditors found that the small business and DVBE subcontractors were independent businesses performing the services mandated in the contract. The audit report noted that the small business and DVBE subcontractors, to varying degrees, independently performed their duties with their primary efforts focused on sales, customer service, issue resolution, training, and outstanding invoice collection activities. The audit report characterized the small businesses and DVBEs, including the firm that provided the online ordering system, as the "face" of the office supplies contract to customers, while it described the role of Office Depot as maintaining the pricing of products on its Web site, filling orders, and arranging the delivery of products to the state customer.

Further, according to the audit report, 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 commercially useful function 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. Based on their review, General Services' internal auditors concluded that the small business and DVBE subcontractors on the Office Depot contract complied with the commercially useful function requirements.

The internal auditors did note some limitations in documentation during their review. The audit report stated that the small businesses and DVBEs generally did not maintain an audit trail of their day-to-day services provided under the contract. The report stated, however, that a number of the businesses were able to provide "anecdotal" evidence of the types of activities they perform on an ongoing basis. Nevertheless, the internal auditors concluded, based on the results of their various procedures, that it was readily apparent that the subcontractors were performing a commercially useful function. Additionally, during their limited review of the Procurement Division's processes used to determine compliance with this requirement before the award of the contract, the internal auditors noted a lack of documentation. The audit report stated that at the time of their review, the Procurement Division's policies did not require the completion of a specific work sheet or other document to capture the results of its assessment. However, based on their interviews with staff and review of the procurement file,

The internal auditors did note some limitations in documentation during their review. For example, small businesses and DVBEs generally did not maintain an audit trail of their day-to-day services provided.

the internal auditors concluded that an adequate assessment was performed. The internal auditors noted that during the review they discussed the need for additional practices that ensure that such decisions are documented adequately and indicated that they were evaluating a new assessment form developed to respond to the concern.

Finally, the audit report's results highlight how much discretion is possible when General Services verifies that proposed work was within each firm's line of business. The internal auditors found that five of the nine subcontractors did not have the office supplies classification listed on their certification, and one subcontractor was not a seller of goods at the time of the award. Specifically, the classifications for four of the nine firms were for office supplies, but the remaining firms indicated they sold closely related products, including computer equipment or software, furniture, and office equipment. However, because the contract included product categories such as computer accessories, office furniture, and small office equipment, the internal audit concluded that General Services' decision to allow the various classifications was consistent with the work to be performed under the contract.

The internal audit confirmed that one small business subcontractor was not a seller of goods at the time of contract award. The internal auditors noted that the subcontractor's Web site indicates that it brings together Fortune 1000 companies to leverage their purchasing power on specific goods, such as office supplies, print and stationery items, packaging, and more. The internal auditors stated the firm obtained a small business certification through General Services, which included a classification code for office supplies, and obtained a sales and use tax permit from the Board of Equalization to participate in the contract. The internal auditors commented that this condition raises concerns about the firm's apparent lack of experience in operating as a reseller. Nevertheless, they concluded that General Services' Procurement Division appropriately deemed this subcontractor to be performing a commercially useful function because state law and policy does not prevent an existing firm from entering into a new line of business to participate in a state contract.

Although the internal auditors did not find any indication that the Office Depot contract violated state laws governing certain requirements, the contract raises some policy questions for the Legislature to consider.

Although the internal auditors' review found no indication that the Office Depot contract violated state laws governing commercially useful function requirements, the contract does raise some policy questions that the Legislature may want to consider further. For example, 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 participation opportunities for these entities? Finally, the contract raises a policy question that is broader than that of compliance with commercially useful function requirements and which the internal auditors indicated was beyond the scope of their review. Specifically, 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 business and DVBE subcontractors rather than the many small businesses and DVBEs that could contract with the State in the absence of strategic sourcing?

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

Although General Services now has a process to identify noncompliance with contract pricing terms for statewide goods contracts, it does not always follow up on the identified noncompliance to ensure prompt recovery of overcharges and does not have a process to help ensure the accuracy of the purchasing data contractors report. General Services believes that individual state agencies making the purchases are responsible for ensuring that contractors comply with the contract's pricing terms. Nevertheless, it has implemented a new process as an additional tool for ensuring compliance with pricing terms. 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 has not yet developed standard procedures to recover overcharges. Further, General Services does not verify the accuracy of the purchasing data that contractors report. Thus, it cannot be certain that contractors always charge the agreed-upon prices.

General Services Had No Routine Process to Monitor Pricing Compliance Until 2008

Before the CASA system was available, General Services did not have a mechanism in place to monitor contractors' compliance with pricing terms for any statewide contracts. A Contracts Unit supervisor noted that General Services has always required contractors to submit usage reports, but prior to strategic sourcing

General Services identifies noncompliance with contract pricing terms for statewide goods contracts, but it does not always ensure prompt recovery of overcharges.

usage reporting was limited to collecting the amounts spent on statewide contracts, and reports primarily were used to determine whether a particular contract experienced enough usage to warrant continuing it as a statewide effort. The supervisor stated that since 2007, General Services has required a more detailed level of usage reporting that includes the specific goods and prices paid by state agencies.

Procurement Division management stated that, even before the implementation of the CASA system, a contract administrator's duties included monitoring the accuracy of contract pricing. They went on to state that because of the labor and time-intensive nature of performing pricing compliance manually, this activity varied by contract and individual contract administrator's workload. Our discussion with the Contracts Unit supervisor confirmed the unit had no routine process to monitor pricing before implementation of the CASA system. The supervisor stated that individual contract administrators had discretion about obtaining purchase orders submitted by state agencies and comparing them with contract prices. Further, contract administrators did not have a formal process for documenting their reconciliation if they performed one. However, by not routinely monitoring contractors' compliance with pricing terms, General Services risked not detecting potential overpayments to a contractor.

Some state agencies paid more for off-contract items—often listed first on the online catalog—than they would have paid for similar items included in the contract.

For example, as a result of the August 2008 General Services' internal audit of the Office Depot contract, General Services determined that state agencies purchased \$16 million worth of office supplies from Office Depot that were not included in the contract because Office Depot's online catalog allowed for state agencies to purchase these off-contract items. In fact, the internal auditors found that search results from the online catalog often presented these off-contract items first instead of the comparable and less expensive contract items. As a result, these state agencies paid more for these items than they would have paid for similar items included in the contract. In recognition of this condition, General Services subsequently negotiated a refund of \$2.5 million for the off-contract items. The internal audit also found that the State was overcharged by more than \$56,000 for items included in the contract.

General Services Contracted With CGI to Include Training and Use of the CASA System

As part of the contract with CGI awarded in December 2007 to provide strategic sourcing training to IAU staff and to develop a procedures manual, General Services required CGI to provide instruction on pricing compliance and use of the CASA system. Maintained by CGI, the CASA system automates the process

of comparing the usage report with the pricing terms of the respective contract. General Services agreed to pay CGI a monthly fee for access to the CASA system that averages \$24,700 a year.¹¹ According to Procurement Division management, General Services did not have the required skill set to develop a compliance tool for pricing validation and savings tracking. The Procurement Division researched existing software applications used within General Services and found no relevant applications that met its business needs. Therefore, it acquired a subscription service for the CASA system.

When a contractor electronically submits a usage report, General Services loads the data into the CASA system. Using the data included in the usage report, the CASA system can produce various reports, including one that identifies the line items in the usage report that potentially conflict with contract terms. Such discrepancies include the purchase of goods not included in the contract or prices that exceed the contract price for that particular item.

The IAU supervisor informed us that although the CASA system became available to General Services in August 2008, system reports were not readily available for contract administrator use until around January 2009 when IAU staff became sufficiently proficient with using the CASA system. Further, General Services does not use the CASA system to monitor all contracts. According to the IAU supervisor, only statewide goods contracts that were awarded, or in some cases amended, after the CASA system's implementation in August 2008 are included. The supervisor also stated that only contracts that have experienced some usage are monitored, which appears reasonable. It has used the CASA system to monitor 35 contracts, some of which are no longer active since the implementation of the system. General Services provided information as of April 2010 that indicated 90 statewide goods contracts were ongoing, of which only 19 were monitored through the CASA system. The other 71 contracts were not actively monitored by the CASA system because they were awarded before implementation of the CASA system or did not experience any usage.

Our review found that the CASA system appropriately gathers data from the usage report and produces a compliance report. Specifically, our review of selected line item purchases for three contracts found that the CASA system appropriately identified instances in which the price on the usage report did

¹¹ The current contract is in place from August 2008 through July 2010. The annual fee increased by 20 percent from \$22,400 in the first year to \$26,900 in the second year.

not agree with the contract price. Further, we found that the CASA system correctly calculated overcharges for items with pricing discrepancies.

General Services' Follow-Up Has Not Always Been Prompt

General Services did not always follow up promptly on the discrepancies and overpayments the CASA system identified for the three compliance reports we reviewed. In one case, General Services did not initially contact the contractor regarding potential overcharges until April 2009, even though the CASA system identified pricing discrepancies with usage reports from as far back as August 2008, eight months earlier. Specifically, the CASA system identified \$6,000 in overcharges for the period August 2008 to April 2009. The contract administrator noted that although General Services had received the usage reports from the supplier for this period, contract administrators did not have access to these reports until early 2009, as discussed previously. The contractor in this case repaid the \$6,000 to General Services in November 2009, one of the options for recovering overpayments allowed by General Services. However, according to the Contracts Unit supervisor, General Services' Accounting Unit informed the Contracts Unit that General Services had no way to distribute the funds to the appropriate state agencies. The contract administrator stated that consequently General Services returned the check to the contractor in February 2010. The contractor informed General Services that it would credit the appropriate state agencies for \$6,000 in overcharges, which it did in May 2010.

A report related to the Office Depot contract identified 120 unresolved discrepancies, including instances in which agencies were allowed to purchase goods no longer available through the contract.

General Services has only recently resolved all the pricing compliance issues related to the April 2009 compliance report for the office supplies contract awarded to Office Depot. This report identified 120 unresolved discrepancies, including instances in which agencies were allowed to purchase goods no longer available through the contract. The CASA system identified more than \$7,000 in overcharges related to these discrepancies. Procurement Division management reported that General Services did not resolve all discrepancies for the Office Depot contract until May 2010, even though the contract ended in May 2009. They acknowledged that the time required to resolve all discrepancies related to this contract was extraordinary. Management attributed the delay to the incomplete data initially received from Office Depot, which prevented the review process from beginning until August 2009, and the unusually large volume of discrepancies. Management also reported that this review led to nearly \$22,000 being credited to state agencies.

General Services has not yet developed standard procedures to recover overcharges. Its current procedures call for the entire pricing compliance resolution process to be resolved within 30 days of receipt of a contractor's usage report. However, as shown in the instances described previously, this process can take much longer than 30 days. Procurement Division management stated that the collection of overcharges is somewhat new, and they have been piloting a reconciliation and collection process using four of the strategically sourced contracts that are still active to develop a standard procedure. For these four contracts, General Services reported that more than \$56,000 in overcharges had been identified as of late May 2010, of which nearly \$15,000 has been recovered. General Services also reported that \$1,500 in overcharges related to another contract that was not part of the pilot was recovered. Further, although they were still working on finalizing the proper amount of overcharges, Procurement Division management indicated that there are 27 other contracts in which potential overcharges were identified by the CASA system. General Services' lack of a standard procedure hinders the prompt resolution of pricing compliance issues and recovery of funds due back to the purchasing state agencies.

General Services Relies on Usage Reports Submitted by Contractors

In addition, General Services relies on the usage data reported by contractors to ensure compliance with contract pricing, but it does not verify the data for accuracy. Thus, an unscrupulous contractor could report to General Services that it charged a particular state agency the contract price when, in fact, it overcharged the agency. The CASA system compares the prices that contractors report they charged to state agencies for various goods, so it would not identify any discrepancies in such situations. Consequently, General Services would be unaware of the overcharges and would not recoup them from the contractor.

Procurement Division 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. Although we agree that state agencies have such a responsibility, discrepancies identified by the CASA system demonstrate that they are not always performing this task effectively. As the State's lead agency with oversight responsibility over procurement, General Services should play a role in ensuring that contractors are charging the agreed-upon prices. In fact, General Services devotes staff resources, as well as pays CGI an average annual fee of \$24,700 to access the CASA system, to identify noncompliance with pricing terms. We believe that to ensure it maximizes the benefits of the CASA system,

General Services' current procedures call for the entire pricing compliance resolution process to be resolved within 30 days of receipt of a contractor's usage report, but this process can take much longer than 30 days.

General Services should take the additional step of periodically verifying that the usage data it receives from contractors are accurate. Working with state agencies to verify that usage data agree with invoices on a sample basis should allow General Services to conduct this work efficiently.

Procurement Division management also noted that, although the CASA system provides a measure of contract oversight, the Financial Information System for California (FI\$Cal)—the State's integrated financial management system currently under development—will provide a significantly enhanced control environment to ensure that state agencies order and pay for goods and services at agreed upon prices. However, according to the Department of Finance's Web site, this new system is not scheduled to be available to the first state agencies until 2012, with the last state agencies scheduled to access the system in fiscal year 2016–17. Finally, even when FI\$Cal is in place, we believe General Services should have a mechanism to ensure that state agencies ensure compliance with contract pricing terms.

Recommendations

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.

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 IAU'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 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.

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.

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.

To ensure prompt recovery of state funds, General Services should implement standard procedures to recover overcharges identified by the CASA system. General Services' new procedures should specify the amount of time it considers reasonable to recover funds due back to the State.

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.

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 participation 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 business 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.

July 2010

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. We limited our review to those areas specified in the audit scope section of the report.

Respectfully submitted,



ELAINE M. HOWLE, CPA
State Auditor

Date: July 8, 2010

Staff: Karen L. McKenna, CPA, Audit Principal
Kris D. Patel
A.J. Meyer
Jack Peterson, MBA
Whitney M. Smith

Legal Counsel: Donna Neville, JD

For questions regarding the contents of this report, please contact Margarita Fernández, Chief of Public Affairs, at (916) 445-0255.

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Appendix

EVENTS RELATED TO THE CONTRACT AWARDED TO OFFICE DEPOT

To implement the strategic sourcing initiative, the Department of General Services (General Services) hired CGI-American Management Systems (CGI) in 2004. As part of its analyses, CGI recommended office supplies as one of the categories of goods the State should strategically source. Based on this recommendation, General Services renegotiated its statewide office supplies contract with OfficeMax in February 2005. In anticipation of the OfficeMax contract's July 2006 expiration date, General Services released a solicitation for a new office supplies contract in April 2006 and awarded the contract to Office Depot in August 2006.

According to General Services, concerns raised about contract activities by a number of small businesses prompted it to direct an audit by its internal auditors in March 2008. The audit focused on Office Depot's compliance with contract provisions governing the pricing of products and the use of small business and Disabled Veteran Business Enterprise (DVBE) subcontractors to provide a commercially useful function. The internal auditors issued their report in August 2008. They concluded that the State purchased products totaling \$14.2 million from Office Depot that were not included in the contract.¹² General Services had negotiated set contract prices for "core items," the items commonly purchased by the State, and a 25 percent to 40 percent discount off retail prices for an additional list of "non-core items." However, the internal auditors found that Office Depot's hard-copy and online catalogs for state agencies included a third category of items and that sales of these off-contract items to state agencies accounted for 35 percent of the total \$40.7 million spent under the contract. According to the internal audit report, a contributing factor was that search results from the online catalog often presented these off-contract items first instead of the comparable and less expensive core items.

The internal audit report concluded that, overall, Office Depot was pricing the approved core and non-core products accurately. However, it identified more than \$56,000 in overcharges. For example, the internal auditors found that Office Depot continued to sell old core items that were no longer included in the contract for a significantly higher price than the new replacement core items. Finally, the internal audit report concluded that, before the contract

¹² According to General Services, the \$14.2 million amount represents the total purchases of off-contract items through the internal audit period of February 2008. General Services announced in August 2008 that \$16 million in off-contract purchases were identified. It stated this amount represented purchases through July 2008.

was awarded, General Services performed an adequate assessment of whether small business and DVBE contractors performed a commercially useful function and that the subcontractors were directly responsible for executing distinct and necessary tasks provided for in the contract. We discuss the commercially useful function requirements and the pertinent internal audit report findings in the Audit Results portion of this report.

Office Depot worked with General Services to take several corrective measures as a result of the internal audit. At the time the internal audit report was released, General Services announced it negotiated an additional discount of \$2.5 million for \$16 million in purchases of off-contract items. General Services subsequently received a refund check for that amount. It indicated that it also had negotiated repayment for the more than \$56,000 in identified overcharges. General Services noted that Office Depot improved its online ordering system to highlight items with the greatest discount in a product category. General Services also stated that it worked with Office Depot to block the State from continuing to purchase restricted items. Such restricted items included digital cameras, televisions, vacuums, and various food items. General Services noted that Office Depot removed certain products from its online catalog. In addition, General Services stated that it reminded state purchasing officers of their responsibilities to manage and supervise their purchasing activities.

General Services' practice is to initiate the contract review process nine to 12 months before the existing contract expires to determine whether it should be extended or whether a new contract should be rebid. However, according to General Services, it did not begin the process to secure a new statewide office supplies contract until June 2008, shortly before the Office Depot contract was scheduled to expire in August 2008. General Services decided to wait until the results of its internal audit were complete to ensure that it applied the lessons learned to the new solicitation. In the meantime, it extended the Office Depot contract from August 30, 2008, when it was scheduled to expire, to February 28, 2009, which is when it intended to award a new office supplies contract. General Services subsequently extended the expiration date three more times, with the contract finally ending May 31, 2009. According to General Services, it did not issue a request for proposal until March 2009 because of the complex nature of developing the request for proposal, including the need to review thousands of line items from the previous bid. Further, it stated that it had to request new proposals due to its determination in December 2009 that the proposals it received were nonresponsive. As of early June 2010, General Services had not yet awarded the new office supplies contract, but expected to do so by mid-July 2010.

Lacking a statewide office supplies contract, state agencies purchased office supplies through their delegated purchase authority for more than a year after the extended Office Depot contract expired on May 31, 2009. In a June 2009 memo, General Services instructed agencies to consult the online eProcurement system to find potential certified California small business or DVBE office supply providers and confirmed that they could continue to use the subcontractors previously listed on the expired Office Depot contract for this purpose.

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(Agency response provided as text only.)

State and Consumer Services Agency
915 Capitol Mall, Suite 200
Sacramento, CA 95814

June 17, 2010

Elaine Howle, State Auditor*
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, CA 95814

Dear Ms. Howle:

Enclosed is our response prepared by the Department of General Services to the Bureau of State Audits' Report No. 2009-114 entitled, Department of General Services: It No Longer Strategically Sources Contracts and Has Not Assessed Their Impact on Small Business and Disabled Veteran Business Enterprises. A copy of the response is also included on the enclosed diskette.

If you have any questions or need additional information, please contact me at (916) 653-4090.

Sincerely,

(Signed by: Bill Leonard)

Bill Leonard, Secretary
State and Consumer Services Agency

Enclosures

* California State Auditor's comments appear on page 63.

MEMORANDUM

Department of General Services

Date: June 22, 2010

To: Bill Leonard, Secretary
State and Consumer Services Agency
915 Capitol Mall, Suite 200
Sacramento, CA 95814

From: Ronald L. Diedrich, Acting Director
Department of General Services

Subject: RESPONSE TO BUREAU OF STATE AUDITS' REPORT NO. 2009-114

Thank you for the opportunity to respond to the Bureau of State Audits' (BSA) Report No. 2009-114 which addresses recommendations to the Department of General Services (DGS) resulting from the BSA's audit of strategic sourcing program activities. The following response addresses each of the recommendations.

OVERVIEW OF THE REPORT

The DGS has reviewed the findings, conclusions and recommendations presented in Report No. 2009-114. The DGS will take appropriate actions to address the BSA's recommendations.

Overall, the DGS is pleased that the BSA's in-depth audit confirmed that the administration's strategic sourcing efforts resulted in at least \$160 million in net savings as of June 30, 2007 and continues to result in ongoing savings to the State. Further, we are pleased that the BSA's review of a sample of strategically sourced contract solicitations found that the DGS followed State laws and regulations in awarding the contracts.

In addition, the BSA recognizes that the DGS takes numerous steps to ensure that small businesses and disabled veteran business enterprises (DVBEs) have an equitable opportunity to participate in State contracts, including strategically sourced contracts. These steps include aiding the firms in contracting with the State through the: maintenance of a streamlined certification process and an online searchable database of small businesses and DVBEs that prime suppliers may use to search for potential subcontractors; conduct of hundreds of outreach activities; and, as was used for the strategically sourced contracts, use of innovative techniques such as networking workshops and contract provisions that allow agencies to forgo purchasing from the mandatory vendor and directly purchase from a small business or DVBE.

The BSA does express concerns that the DGS has not entered into any new strategically sourced contracts since the 33 entered into between January 2005 and July 2006. The DGS remains fully committed to continuing strategic sourcing as one of the types of procurement techniques that is available for use in leveraging the State's buying power. However, the department is in the relatively early stages of implementing this technique. Specifically, because of the almost complete turnover of staff since the original sourcing efforts were performed, the DGS Procurement Division's (PD) acquisition staff required additional strategic sourcing training that was not completed until September 2009. It should be noted that, as recognized by the original strategic sourcing contractor, optimal data is also not readily available for the DGS to conduct full strategic sourcing efforts due to the State lacking a single accounts payable/purchasing

Bill Leonard

-2-

June 22, 2010

data system. Therefore, at this time, the DGS' procurement efforts may be restricted to conducting a more limited version of the strategic sourcing process than was used by the contractor, CGI-American Management Systems (CGI), which assisted in implementing strategic sourcing.

The BSA also expresses the concern that the DGS had not prepared any comprehensive analysis documenting its rationale for not strategically sourcing 20 additional categories of goods or services identified in CGI's report that were recommended for potential sourcing. After an assessment of opportunities for savings had been performed by CGI, the DGS conducted solicitations within ten categories that were identified for sourcing. These ten categories were the only ones that were fully developed as part of the process, including the development of detailed business cases.

As stated by the BSA, the DGS is in the process of reviewing the 20 additional categories that were presented in CGI's report. This review is in its final stages and, to date, has not determined that any of the 20 categories warrant strategic sourcing. In brief, for many of the categories such as the commercial airline, rental car, telecommunications and travel agency categories, the DGS has used other traditional acquisition techniques to acquire those goods or services. These techniques accomplished the same goal as strategic sourcing including competitively leveraging the State's buying power to obtain lower pricing. The remaining categories, such as architectural and engineering services, electricity and leased real property, are of such a broad nature that it is unclear as to how strategic sourcing techniques could be applied to those goods or services.

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In addition, the BSA expresses the concern that the DGS does not track the change in the number of small businesses and DVBEs participating in a category of goods that has been strategically sourced. Although the DGS will determine the viability of separately tracking strategically sourced contract usage before and after sourcing, it should be noted that the strategically sourced contract category is estimated to represent less than 1.5% of the total \$9 billion in State agency contract awards issued during the 2008/09 fiscal year.

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Currently, the DGS tracks the use of small businesses and DVBEs in State contracting through the information provided in the Consolidated Annual Report prepared as required by Public Contract Code Section 10111. Since the advent of strategic sourcing during the 2004/05 fiscal year, the participation of small businesses and DVBEs in overall State contracting has increased, which reflects favorably on the administration's commitment to the use of these businesses to provide goods and services to the State. Specifically, small business usage increased from 21.96% in 2004/05 to 26.88% in 2008/09, while DVBE usage increased from 1.72% to 2.96%.

The success of the State's contracting program's use of small businesses and DVBEs has been focused on overall usage and not by type of acquisition methodology. As with all of the various types of State procurements including consulting services contracts, delegated purchases, and leveraged procurement agreements such as strategically sourced procurements, the State does not track the effect an individual type of acquisition methodology has on contracting with small businesses and DVBEs. However, the DGS fully considers the impact on those types of firms prior to performing any acquisition and attempts to fully mitigate any potential negative impacts to the extent it is in the State's best interest.

The BSA also provides recommendations related to improving the State's program for the monitoring of small business and DVBE subcontractors for compliance with contract participation goals and the PD's processes for the monitoring of contractor price compliance and recovery of overcharges. The DGS is taking appropriate actions to fully address those issues.

Bill Leonard

-3-

June 22, 2010

The DGS appreciates the BSA's in-depth audit and is fully committed to promptly and completely addressing the issues identified in the audit report. In general, the actions recommended by the BSA have merit and will be promptly addressed.

RECOMMENDATIONS

RECOMMENDATION # 1: *To ensure that it determines the savings to the State going forward for strategically sourced contracts, General Services should examine the State's recent purchase 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.*

DGS RESPONSE # 1:

The PD will develop standards for implementing and documenting an evaluation of recent purchase patterns when determining whether to rebid or extend previously sourced contracts. Further, as part of its opportunity assessment process, when feasible, PD's Intake and Analysis Unit (IAU) will implement a process that includes the estimation of expected savings for any rebid or extended contracts based on those purchase patterns.

It is foreseen that this process will provide for the performance of a market survey to identify baseline pricing for use in estimating expected savings. Where applicable, the market survey will include a review of the pricing obtained by other States and through various government contracting vehicles, such as the Western States Contracting Alliance, for the goods being strategically sourced. Subsequently, the baseline savings amounts will be compared to the actual pricing obtained under the contracts to calculate achieved savings.

RECOMMENDATION # 2: *To ensure it has maximized the savings for CGI-recommended categories that it did not strategically source, General Services should conduct its planned review of those categories to determine if there are further opportunities to achieve savings.*

DGS RESPONSE # 2:

The DGS is actively reviewing the 20 additional categories that were presented in CGI's report as potential strategic sourcing categories. As part of the review, the IAU's staff, which have been trained in strategic sourcing, have been tasked with analyzing the categories to determine if there are opportunities to achieve further savings. Further, CGI is being contacted to obtain additional details on the recommended categories.

RECOMMENDATION # 3: *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 IAU'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*

Bill Leonard

-4-

June 22, 2010

it obtains such data, General Services should work with state agencies to identify detailed purchases for those categories that it identifies through 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.

DGS RESPONSE # 3:

The PD is taking actions to ensure that the issues included in this recommendation are fully addressed. As part of this process, the IAU has been tasked with being the front door to the PD through which all workload coming into the division is logged and tracked. This allows that unit to be aware of the type and volume of both one time acquisition and statewide commodity contract requests that may lend themselves to the strategic sourcing process. In consultation with its customers, the PD will then utilize available data on the purchasing patterns for the goods to identify if strategic sourcing or another procurement vehicle should be used to acquire the goods. In performing its opportunity assessments, the IAU will use the data available in eSCPRS and other sources, such as internal State agency systems that contain relevant purchase data, to assist in the spend and savings analysis process.

RECOMMENDATION # 4: *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.*

DGS RESPONSE # 4:

The DGS fully considers the impact on small businesses and DVBEs prior to performing any acquisition and attempts to fully mitigate any potential negative impacts to the extent it is in the State's best interest. As a result of this recommendation, the PD will assess the programmatic benefit and feasibility of identifying the number of small businesses and DVBEs awarded contracts prior to the award of new strategically sourced contracts. As to tracking the use of those firms after a strategically sourced contract has been awarded, the PD has tasked the management team that is reviewing the off ramp policy (see response to the following recommendation) to determine the viability of State agencies reporting this degree of detail.

Bill Leonard

-5-

June 22, 2010

RECOMMENDATION # 5: *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 should also 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.*

DGS RESPONSE # 5:

The PD has tasked an internal management team with the responsibility for developing criteria governing the use of small business and DVBE off ramps in statewide contracts. As part of this process, the team has been tasked with determining the viability of tracking off ramp usage to determine its effectiveness in providing opportunities for small businesses and DVBEs to participate in contracts with State agencies even though mandatory statewide contracts exist. If deemed viable for collection, the information will also be used by the PD to track the monetary impact of State agency off ramp usage in contrast to using an applicable statewide contract.

RECOMMENDATION # 6: *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.*

DGS RESPONSE # 6:

The PD's contract administrators and State agency contract managers jointly have the responsibility for ensuring that prime contractors make a good faith effort to comply with small business and DVBE contract participation goals. To ensure that State agency personnel are aware of their responsibilities, the PD will ensure that user instructions for future statewide contracts contain provisions that fully inform the user agency of small business and DVBE contractor usage and agency monitoring requirements.

Since the DGS has general oversight responsibilities for the use of statewide contracts, as recognized in the BSA report, the PD already has procedures in place for its contract administrators to monitor small business and DVBE usage through the review of usage reports and meetings they periodically have with contractors throughout the life of each contract. To increase the awareness of contract oversight responsibilities, the PD is also in the process of implementing the use of Contract Management Plans that clearly document the responsibilities of a contract administrator prior to the start of a contract. Where applicable, these plans will include the requirements for monitoring contractor compliance with small business and DVBE participation requirements.

Bill Leonard

-6-

June 22, 2010

RECOMMENDATION # 7: *To ensure prompt recovery of state funds, General Services should implement standard procedures to recover overcharges identified by the CASA system. General Services' new procedures should specify the amount of time it considers reasonable to recover funds due back to the State.*

DGS RESPONSE # 7:

The PD is currently developing standard procedures to recover any overcharges, including the amount of time considered reasonable to recover funds due back to the State. The procedures will provide for the prompt issuance of a cure letter upon identification of an overcharge amount. The PD will also promptly follow-up to collect any delinquent amounts.

RECOMMENDATION # 8: *To improve the integrity of its monitoring of pricing compliance, General Services should implement procedures to help ensure 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.*

DGS RESPONSE # 8:

The PD will implement procedures to assist in ensuring the accuracy of the usage reports submitted by contractors. Specifically, the previously discussed Contract Management Plan process will include steps for the contract administrator to work with State agencies to confirm the accuracy of contractor reported pricing and other relevant data.

CONCLUSION

The DGS is firmly committed to effectively and efficiently overseeing the State's procurement program. As part of its continuing efforts to improve this process, the DGS will take appropriate actions to address the issues presented in the report.

If you need further information or assistance on this report, please contact me at (916) 376-5012.

(Signed by: Ronald L. Diedrich)

Ronald L. Diedrich, Acting Director
Department of General Services

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Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE DEPARTMENT OF GENERAL SERVICES

To provide clarity and perspective, we are commenting on the response to our audit report from the Department of General Services (General Services). The numbers below correspond with the numbers we placed in the margins of General Services' response.

General Services contends that the traditional acquisition techniques it used accomplished the same goal as strategic sourcing. However, as we state on page 22, General Services has not determined whether the contracts it issued have achieved the same level of benefits that they could have using strategic sourcing. Thus, it has not demonstrated that it achieved the maximum savings possible to the State.

General Services provides an estimate of the percentage of contract awards issued during fiscal year 2008–09 that the strategically sourced contract category represents. However, as we note on page 22, General Services has not entered into strategically sourced contracts since its initial efforts. General Services subsequently explained that the 1.5 percent it cites in its response primarily represents the purchase orders state agencies issued during fiscal year 2008–09 when purchasing through the originally awarded or extended strategically sourced contracts.

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cc: Members of the Legislature
Office of the Lieutenant Governor
Milton Marks Commission on California State
Government Organization and Economy
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
Capitol Press