

**State
Contracting:**
Reforms Are Needed To Protect
the Public Interest

August 1996
95015

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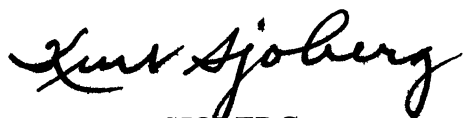
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The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As required by Chapter 1044, Statutes of 1990, the Bureau of State Audits presents its audit report concerning its review of the State's compliance with state laws and regulations for contracts for July 1, 1994, through June 30, 1995. This report discusses deficiencies that have occurred in contracts between state departments and their contractors. We found that some state departments have executed interagency agreements with California State University or contracts with community colleges and campus foundations to accomplish work that is ultimately performed by private subcontractors. In these instances, millions of dollars of work was awarded to subcontractors without soliciting bids from other consultants. Moreover, many of these contracts involve multi-tiered administration that creates excessive costs to the State. Also, we determined that, in some cases, the contracting department has identified a specific subcontractor before signing the agreement with the university or foundation. In effect, these departments are entering sole-source contracts and, in so doing, are avoiding important controls over the State's contracting process. Finally, some state departments did not properly manage contract funds, monitor compliance with contract terms, or comply with other contracting requirements.

Respectfully submitted,



KURT R. SJOBERG
State Auditor

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Summary




Audit Highlights . . .

State departments have misused interagency agreements and have inadequately justified other sole-source contracts. By doing this:

- Private contractors receive millions of dollars of work without competition.**
- The state departments incur unnecessary administrative expenses through multi-tiered agreements.**

Further, departments are not always adequately managing contract funds or monitoring the contractors' compliance with the terms of contracts and interagency agreements.



Results in Brief

In this and in previous audits, we have found deficiencies in contracts between state departments and their contractors. These deficiencies have occurred because the departments' management of contracts and interagency agreements, current contract law, and the State's existing system for overseeing contracts have failed to prevent recurring contract deficiencies.

Current contract law and the State Administrative Manual identify allowable exemptions from advertising and competitive bidding requirements and also permit the limited use of sole-source contracts by departments when certain conditions are met. Many state departments award sole-source contracts, which are agreements entered without the departments' requesting or evaluating other contract proposals, justifying their decisions by citing these allowable exemptions from advertising and competitive bidding. However, in some cases, departments have not demonstrated that sole-source contracts were needed or in the best interest of the State.

In addition, we determined that state departments have entered interagency agreements with California State University (CSU), the University of California (UC), or contracts with community colleges and campus foundations to accomplish work ultimately performed by private subcontractors. In these instances, the work is awarded to subcontractors without soliciting bids from other consultants. In some cases, the contracting department identified a specific subcontractor before signing the agreement with the university or foundation.

We agree that allowing departments to use interagency agreements and exempt contracts can be beneficial when such agreements encourage the efficient use of existing public resources. However, by entering sole-source contracts with private parties in this way, departments are not taking advantage of the expertise present at CSU, UC, or the community colleges, and they are avoiding important controls over the State's contracting process.

During our review, we also found instances in which interagency agreements or exempt contracts resulted in multi-tiered arrangements that unnecessarily added multiple levels of contract bureaucracy and administration, thus increasing the indirect cost of services provided to the State. In other recent audits, we provided examples of similar contracting arrangements, including examples of weak controls and lax accountability.

The Legislature has proposed reforms to the State's current acquisition process. This proposed legislation does not apply to contracts entered into by CSU, nor does it specifically address exempt contracts with UC, the community colleges, or auxiliary organizations. As a result, we believe that the proposed legislation will not significantly improve problems we found related to interagency agreements and exempt contracts.

Further, we found that state departments have entered into poorly planned contracts and interagency agreements and that state departments do not always adequately manage contract funds, monitor compliance with contract terms, or comply with other administrative requirements. Because of these deficiencies, as well as similar problems identified in other recent Bureau of State Audits reports, we conclude that parts of the current contracting process are ineffective.

Our review of eight state departments revealed the following specific concerns:

- For 8 of the 28 interagency agreements reviewed, state departments received the services of private subcontractors by using interagency agreements and exempt contracts that avoided competitive bidding.
- For the same eight interagency agreements discussed above, the departments paid fees to CSU for administering these subcontracts, even though the departments played an active role in administering the same contracts.
- Existing contract law and proposed reforms do not address problems we identified with interagency agreements and contracts.
- Some departments failed to recover advance payments to contractors until after the related contract had expired.

- State departments' planning and management of contracts and interagency agreements do not always protect the public interest. For example, some departments have entered contracts and interagency agreements that do not specify the basis for fees to be paid. In addition, departments do not always monitor contract payments to ensure compliance with the Public Contract Code or the terms of the contract.

Recommendations

To ensure that exemptions from requirements for advertising and competitive bidding are in the best interests of the State, departments should request these exemptions only when they can sufficiently demonstrate that just one contractor can provide the services.

In addition, state departments should ensure that they do not use interagency agreements and exempt contracts to circumvent existing state contracting practices.

The California Legislature should consider adopting legislation that prohibits departments from using interagency agreements and exempt contracts to receive contract services from private subcontractors without the departments' using a competitive process.

To ensure that expenditures are economical and reasonable, state departments should plan contracts adequately to include all the elements necessary to monitor contractor performance and evaluate the goods and services received.

If advance payments are necessary, state departments should make only small periodic advances. Departments should also liquidate advances before making additional progress payments and verify the recovery of unspent advances at the end of the contract period.

To protect the State's interests, state departments should ensure that they and their contractors comply with the contract terms and any statutory or administrative requirements.

Agency Comments

In responding to our report, the departments generally agreed that the State's management of contracts and interagency agreements can be improved.

Introduction

The California Public Contract Code and the State Administrative Manual establish basic guidelines and procedures that state contracting and oversight agencies must follow when entering into or approving contracts. For example, agencies must comply with requirements for advertising the availability of contracts, soliciting bids from potential contractors, evaluating the bids, writing the contracts in conformity with state requirements, obtaining the appropriate approvals, approving payment for services, and completing an evaluation when the contract is completed.

In addition, California law places specific requirements on state departments using consultant contracts. The California Public Contract Code, Section 10356, describes consultant contracts as those which provide services of an advisory nature, such as recommending courses of action. This section also identifies certain types of agreements that do not fit into the consultant contract category, including contracts between state agencies and the federal government, contracts with local agencies, and contracts for architectural and engineering services. A consultant contract usually results in the delivery of a report related to the governmental functions of state agency administration and management. In addition, consultant service contractors are unlike other contractors, who must only be notified that they are at risk, in that they are explicitly prohibited from rendering services before the State approves their contracts.

The California Public Contract Code generally assigns to the Department of General Services (DGS) the duty of reviewing and approving contracts entered into by state agencies. In addition to its responsibilities for ensuring compliance with legal provisions for each contract submitted for its approval, the DGS has broader oversight responsibilities. For example, its Office of Legal Services is responsible for developing the standard contracting procedures contained in the State Administrative Manual. These procedures are designed to aid public officials in the efficient and, to the maximum extent possible, uniform administration of public contracting. In addition, the DGS periodically performs management audits of other state departments' contracting practices. The DGS also maintains a central depository of negative contractor evaluations and makes them available to other departments upon request.

The DGS does not provide oversight responsibility for the contracting program of California State University (CSU), nor does it review or approve CSU's contracts. Instead, CSU's Chancellor's Office provides contract management guidance to its campuses, as directed in Sections 2400 and 2500 of its State University Administrative Manual, which generally mirror requirements in the State Administrative Manual.

Scope and Methodology

This audit fulfills the fiscal year 1994-95 requirements of Chapter 1044, Statutes of 1990. These statutes require the Office of the Auditor General to evaluate annually the State's compliance with state laws and regulations for consultant contracts. The Bureau of State Audits assumed the responsibility for these audits pursuant to the Government Code, Section 8546.8.

To evaluate the State's compliance with the laws and policies governing contracts, we reviewed the California Public Contract Code and the State Administrative Manual and identified the provisions and policies pertaining to consultant contracts, interagency agreements, and other contracts. We determined compliance with relevant laws and policies by reviewing consultant contracts, interagency agreements, and other contracts at the eight state departments listed below:

- Department of Alcohol and Drug Programs
- Department of Corrections
- Employment Development Department
- Department of General Services
- Department of Motor Vehicles
- Office of Statewide Health Planning and Development
- Department of Parks and Recreation
- Department of Transportation

According to their own records, for fiscal year 1994-95, the eight departments we reviewed entered 479 consultant service contracts totaling approximately \$34.7 million. In addition,

these departments contracted with public and private entities for significant amounts of other goods and nonconsultant services. We selected a sample of the various types of contracts, interagency agreements, and related amendments and tested for appropriate contract language and provisions, supporting documentation, and approvals. In addition, we reviewed contracts and interagency agreements to determine if the departments administered those agreements in the best interest of the State.

We reviewed the California Public Contract Code and the State Administrative Manual and identified those provisions and policies applicable to sole-source contracts. We also examined the consultant contract reports at eight departments to identify sole-source contracts awarded during the 1994-95 fiscal year.

We did not audit the contracting procedures of the California State University, the University of California, the Chancellor's Office of the California Community Colleges, or the auxiliary organizations of these entities. However, when we had concerns with interagency agreements or exempt contracts between these entities and state departments, we discussed those concerns with the appropriate representatives.

To determine whether the DGS fulfilled its responsibilities to oversee state departments with delegated authority to procure consultant services, we reviewed the California Public Contract Code and the State Administrative Manual provisions and policies applicable to this delegated authority. We also obtained from the DGS the status report of the state departments' internal audits to determine the timeliness of the DGS in reviewing those audits.

Chapter 1

State Departments Often Avoid the Competitive Bidding Process by Misusing Interagency Agreements

Chapter Summary

Because many state departments spend a significant portion of their budgets on contractual services, departments need to award and manage contracts prudently in order to control department expenditures effectively. According to its own records, during fiscal year 1994-95, the Department of General Services (DGS) approved approximately 9,600 contracts and amendments totaling approximately \$5.8 billion entered into by state departments. The DGS also delegated to various state departments approval authority for contracts below certain dollar amounts. These smaller contracts are not accounted for centrally, and therefore are not included in the numbers listed above.

By outlining specific competitive bidding requirements, California law recognizes the importance of proper procedures for awarding contracts. These requirements facilitate the competitive award of contracts, allowing the State to obtain the best available services at the most reasonable prices. However, the bidding process can also be time-consuming and expensive. The Public Contract Code therefore exempts from advertising and competitive bidding requirements certain contracts and agreements, including contracts that allow for emergencies and agreements between two state agencies (interagency agreements). The Public Contract Code also exempts contracts between state departments and auxiliary organizations of California State University (CSU) and the Chancellor's Office of the California Community Colleges (COCCC). These agreements are advertised as a way for departments to use existing state resources and provide improved public service without adding unnecessary costs related to administering the bidding process or profit paid to a private vendor.

At the eight departments we visited, 64 percent of the 479 consultant contracts were "sole source." In other words, the department had awarded the contracts without seeking competitive bids. While it is appropriate to award sole-source

contracts in some instances, we found that departments had not always demonstrated that these contracts were needed or in the best interest of the State. We also found that state departments have misused interagency agreements with CSU and have thus avoided existing controls over state contracting. This misuse has resulted in departments' awarding services to private contractors without soliciting competing proposals from other sources. The misuse of these interagency agreements has also increased the cost of services received by the State.

While we agree that excluding interagency agreements from advertising and competitive bidding requirements promotes the efficient use of existing state resources, state departments have misused interagency agreements. Current legislation and statewide administrative requirements allow state departments to enter into interagency agreements without advertising or competitive bidding so that one department may take advantage of existing public resources to provide expert services to another department. However, the misuse we identified has resulted in limited or no competition and potentially increased the cost of services received by the State.

State Departments Award Many Contracts Without Seeking Competitive Bids

The eight departments selected for review reported awarding 479 consultant contracts totaling \$34.7 million during the 1994-95 fiscal year. Of these, 306 consultant contracts (64 percent) totaling \$16.8 million were sole-source contracts. Many of these sole-source consulting contracts met the established criteria for exemption from competitive bidding. However, we found that departments did not always demonstrate that sole-source contracts were in the best interest of the State. Instead, departments used the following explanations to justify sole-source contracts:

◆
Departments' justifications for sole-source contracts were often weak.

- "The contractor's expertise was essential to the department in performing the contract within the established deadline."
- "The contractor has considerable expertise in this area."
- "The contractor's knowledge and expertise to implement the study in a timely and cost-effective manner is crucial."

◆
These explanations do not confirm that only one contractor could reasonably provide the services requested or that awarding these contracts without a competitive process is in the best interests of the State.

At two departments, the use of interagency agreements led to unnecessary costs.

We also found instances in which the use of agreements between two state agencies (interagency agreements) led to unnecessary costs and the award of contracts without seeking competitive bids. For example, the Department of Parks and Recreation (department) identified a physician with back-injury expertise to conduct back-safety training courses for department employees. Because department staff recognized that "sole-source contracts were to be discouraged," they did not contract directly with the physician. Instead, they used an affiliation between the physician's medical group partner and the University of California at Los Angeles (UCLA) to establish an interagency agreement with UCLA, which then subcontracted with the physician. As part of this interagency agreement, UCLA charged the department 21.9 percent of the total subcontract costs for processing the interagency agreement, tracking charges against the contract, and processing payments to the physician. Since the department was required to perform these same functions to pay UCLA, this agreement was not cost-effective. In addition, the department denied other physicians the opportunity to compete for a \$41,000 contract.

In a prior audit, we identified as sole source 55 percent of the 1,688 consultant contracts awarded during the 1993-94 fiscal year at 19 departments. Although we agree that sole-source contracts are appropriate in some instances, our audits raise questions as to whether sole-source contracts are always adequately justified or in the best interest of the State.

In most instances, it is a sound business practice to seek competing proposals before obtaining the services of a consultant. When it eliminates competition, the State denies potential bidders the chance to compete for contracts, and the contracting organization may pay more than necessary for the consultant's services.

Departments Are Misusing Interagency Agreements and Exempt Contracts

During the 1994-95 fiscal year, the DGS approved more than 330 agreements and amendments, totaling \$48.7 million, between state departments and CSU or its auxiliary organizations (foundations). The DGS also delegated to state departments the approval authority for interagency agreements below certain dollar amounts. These agreements between state departments and CSU are not included in the above numbers because they are exempt from DGS approval and are not accounted for centrally.



—◆—
Although intended to take advantage of existing public resources, in 8 of 28 instances, departments used interagency agreements to obtain the services of private contractors.
—◆—

The CSU Chancellor's Office established the University Services Program to provide a systemwide network of services and expertise to state departments. The departments obtain these services by entering interagency agreements with the Chancellor's Office, which then contracts with campus foundations. The state departments also enter exempt contracts for services directly with the foundations. The California Public Contract Code exempts from competitive bidding contracts with foundations and the Chancellor's Office.

We reviewed 28 of these agreements and 39 related amendments, totaling \$10.4 million, between state departments and the CSU Chancellor's Office or foundations. For some or all of the work related to 8 agreements reviewed, the foundations did not provide the consultant services for the departments. Instead, the foundations acted as intermediaries between the departments that requested the services and the subcontractors that ultimately provided the services.

For example, in fiscal year 1994-95, the Department of Alcohol and Drug Programs (DADP) entered an agreement with CSU totaling \$50,000 for assistance with executive team development and staff training. In addition, we found that between 1989 and 1996, the DADP entered into at least 16 other agreements and amendments with CSU, totaling approximately \$808,700, for the same or similar services. However, CSU did not provide these services, but instead contracted with two campus foundations. These foundations subcontracted with the same executive training consultant for all the direct services provided to the DADP. When we asked the foundations to provide evidence that these subcontracts were bid competitively, they were unable to do so.

While reviewing consultant contracts at the Employment Development Department (EDD), we found that the EDD had entered into a one-year agreement with CSU for "on-call" consulting services and management training beginning in fiscal year 1993-94 totaling \$270,338. Again, CSU did not provide the "on-call" services; instead, it contracted with a campus foundation that subcontracted for the services requested by the EDD to the same executive training consultant discussed in the previous paragraph. In addition, the EDD amended the agreement four times, extending the "on-call" services for 11 additional months and increasing the amount of the agreement by \$252,237, an increase of 93 percent over the original amount. Similarly, between 1991 and 1993, the EDD entered into five other agreements and amendments with CSU that totaled \$585,595 for training services. Again, the foundation could not provide evidence that they had used a competitive bidding process to select the consultant.


By using interagency agreements, two departments avoided competitive bidding and awarded over \$2 million to one private contractor.


The original intent behind the State's exempting contracts and interagency agreements from competitive bidding requirements is valid. However, the departments have gone beyond the intent of these exemptions. Rather than using existing government resources, the departments have misused interagency agreements and exempt contracts to enter sole-source contracts with private parties. In some cases, the department identified the subcontractors prior to the agreement with the university or foundation. The departments have, in effect, awarded sole-source contracts to private consultants without obtaining the approvals that are normally required when the department follows the usual contracting process.

Because interagency agreements and contracts between state departments and CSU or the foundations are exempt from competitive bidding requirements, the departments can enter into these arrangements without violating existing contracting requirements.

Further, since the executive training consultant in the two examples above was not selected through a competitive process, the campus foundations denied other consultants the opportunity to compete for at least \$2 million in state contracts. These foundations also cannot assure that they obtained the best available services at the most reasonable price.

Similarly, in August 1995, we reported that the Department of Rehabilitation (DOR) circumvented state competitive bidding requirements. Specifically, the DOR directed its contracting unit to inappropriately use interagency agreements with California State University, Long Beach (CSU Long Beach), to obtain training for its clients. The interagency agreements contained specific language that required CSU Long Beach to subcontract with selected individuals and organizations. By entering into the interagency agreements, the DOR avoided competitive bidding requirements.

The Public Contract Code also exempts from the competitive bidding process contracts between state departments and the California community college districts. For one agreement reviewed, we found that the EDD entered a contract with Sierra Community College District (Sierra) that established a training program on workforce diversity for the EDD's managers and supervisors. Instead of having Sierra college faculty or staff provide training services to the department, Sierra subcontracted with a private consultant. Sierra staff stated that, because community college districts are not required to bid this type of training contract competitively, Sierra selected the private consultant without using a competitive process. In addition, the EDD paid Sierra a 10 percent fee for administering

the contract. Again, we question the cost-effectiveness of exempt agreements when state agencies or departments do not use existing public resources.

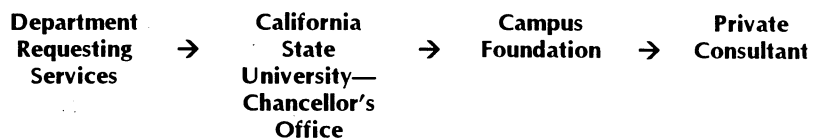
In an audit report issued in January 1996, we noted that the COCCC and the Department of Education circumvented state controls to obtain the services of a specific contractor. By contracting with the community college districts, the department and the COCCC were able to select specific contractors without obtaining sole-source approvals. The COCCC and the Department of Education paid nearly \$62,000 in administrative costs in addition to \$805,000 that the districts paid to the contractor on behalf of the two agencies. By circumventing the competitive bidding process, the two agencies cannot confirm that they employed the most qualified contractor or that the amount paid to the contractor was reasonable.

***Multiple Levels of Contract Administration
Result in Excessive Costs***

We found that departments used a type of multi-tiered arrangement for 8 of the 28 interagency agreements with CSU. Because they create unnecessary expenses, we question the cost benefit of multi-tiered interagency arrangements that departments enter to secure the services of a specific consultant. Although it is reasonable to pay contractors for their indirect costs, in most instances departments would reduce the total cost to the State and increase cost efficiency by contracting directly with the consultant.

◆
*Departments would
reduce administrative
costs by contracting
directly with consultants.*

The marketing brochures for CSU's University Services Program promote interagency agreements as a way for departments to "save California tax dollars by using publicly developed resources." The structure of these multi-tiered arrangements begins with the department that needs the contracted services entering into an interagency agreement with an intermediary, such as CSU. The intermediary then contracts with a campus foundation, which in turn subcontracts with a private consultant who provides the services that the originating department has requested. The following diagram depicts the flow of contract dollars in these multi-tiered arrangements:





For example, two departments paid CSU \$393,371 to administer a subcontract that they were also actively administering.

In the two examples involving the executive training consultant, the departments agreed to pay CSU 25 percent of the subcontractor's costs for contract administration even though the departments worked directly with the subcontractor and reviewed and approved their invoices prior to payment by CSU. In other words, the departments agreed to pay \$393,371 to CSU for contract administration even though the departments played an active role in administering the same subcontract.

In another example, the Department of Transportation (Caltrans) entered an agreement with CSU for monitoring birds affected by various Caltrans construction projects. This study was required by state and federal regulations and was consistent with the broad range of services offered by CSU's University Services Program. Again, CSU did not provide the services but instead contracted with a campus foundation that subcontracted with the Point Reyes Bird Observatory (bird observatory). The bird observatory provided some services and subcontracted the remaining services to yet another subcontractor. The bird observatory submitted invoices to the foundation that included direct costs of providing the services and the administrative costs associated with managing the subcontract. The foundation then billed CSU for the total subcontractor costs plus an additional 25 percent of that total. CSU submitted invoices to the department for total amounts charged by the foundations. For the invoices we reviewed, Caltrans approved payment of \$166,542, including \$30,009 for bird observatory costs associated with managing its subcontract with the foundation, and \$30,233 for the foundation's management of the same subcontract.

***Existing Contract Law and Department
of General Services Oversight Do Not
Ensure the Appropriate Use of Interagency
Agreements***

The DGS oversees the contracting practices of state agencies. As part of this oversight authority, the DGS is responsible for review and approval of all contracts and interagency agreements, unless exempt according to statute, state regulation, or delegated authority granted by the DGS. Specifically, the DGS is to ensure that departments comply with state laws, rules, and regulations and that departments make expenditures as wisely and economically as possible in order to protect and preserve the best interest of the State. The contract review and approval process is intended to assist the DGS in fulfilling these responsibilities. However, existing contract law does not explicitly prohibit departments from using interagency


Current oversight efforts are not designed to detect interagency agreement abuses.


agreements as a way to subcontract with private-sector consultants and avoid awarding this work through a competitive process. Also, the contract review performed by the DGS is not designed to detect all of the problems discussed previously. As a result, current oversight efforts do not always protect the best interest of the State.

As discussed previously, existing legislation exempts interagency agreements from advertising and competitive bidding requirements. This exemption allows for an efficient use of existing state resources, such as the faculty, staff, or students of CSU, the University of California, or the State's community colleges. Nonetheless, we found that 4 of 39 interagency agreements or exempt contracts approved by the DGS were subcontracted to private entities without the benefit of competitive bidding. As a result, neither existing legislation nor current oversight efforts have prevented departments from circumventing prudent contracting practices.

Proposed Reforms Do Not Address Problems With Interagency Agreements and Contracts

In early 1996, legislation was proposed that would replace the current contracting process. The California Acquisition Reform Act of 1996 (CARA) would reform the current state acquisition process by simplifying and clarifying the process while assuring that the business needs of the State are still met. The primary focus of the CARA is the acquisition of goods and services from nongovernmental sources, and the proposed legislation does not specifically address problems we identified in contracts between two state agencies nor in contracts between state departments and CSU, UC, and the community colleges, or their auxiliary organizations. Therefore, the proposed legislation continues to allow departments to use interagency agreements or other exempt contracts as ways to subcontract with private-sector consultants without awarding the work through a competitive process.

Conclusion

State departments have misused interagency agreements with CSU, UC, and the community colleges and have avoided existing controls over state contracting and have added excessive costs to the contracting process. For such agreements, the existing contract law does not require departments to advertise for services nor to solicit competitive

bids because these agreements are designed so that one government agency agrees to provide the expert services of its staff or faculty to another agency. However, the departments are not having public employees, such as CSU faculty, perform the services needed; instead, the departments are, in effect, using the interagency agreements to enter sole-source contracts with private parties. In doing so, the departments have added excessive costs to the contracting process.

Although proposed legislation would implement current efforts to reform the State's acquisition process, this reform effort does not specifically address the problems identified in this report. As a result, we believe that the proposed legislation will not resolve all of the problems arising from interagency agreements and exempt contracts.

Recommendations

To ensure that exemptions from advertising and competitive bidding are in the best interest of the State, departments should request these exemptions only when they can sufficiently demonstrate that a specific contractor can provide the services.

In addition, the use of interagency agreements and exempt contracts should be restricted to the proper utilization of existing public resources; such agreements should not be tools for avoiding existing state contracting practices. State departments should contract directly with private parties when appropriate rather than using interagency agreements and exempt contracts to avoid competitive bidding.

The California Legislature should consider adopting legislation prohibiting departments from misusing interagency agreements and exempt contracts to obtain contract services from nonpublic resources without employing a competitive process.

Chapter 2

Inadequate Contract Administration Results in Inefficient Use of Public Resources

Chapter Summary

Efficient contract administration by state departments is necessary to the State's sound fiscal management. Conversely, poorly developed or managed contracts can result in the inappropriate or inefficient use of state resources, substandard services provided to the public, lawsuits against the State, loss of federal funding, or public embarrassment.

During our review, we found that departments did not always ascertain that sufficient funding was available to complete the contracted work, specify in the written contract the contractor's required deliverables, or detail in the contract the basis for contractor payment. When a department does not ensure that sufficient funding is in place before awarding a contract, it jeopardizes its ability to realize the objectives of the contract. Further, without establishing benchmarks to allow for comparison with the results achieved, the department cannot adequately monitor its agreements with contractors, verify that amounts paid are reasonable, or determine that services or goods received are consistent with the contract terms.

Background

According to the State Administrative Manual, the essential elements of effective contract management include the following:

Planning

- Developing a clear, precise scope of work with specific measurable deliverables and benchmarks that can be monitored and managed.
- Identifying qualified contractors and facilitating competition so the State receives the best goods or services for the most reasonable price.

Monitoring

- Monitoring and evaluating contractor work performance, both quantity and quality, in relation to the contract terms and conditions.

Evaluating

- Reviewing requests for payment to ensure that payment is consistent with the deliverables received.
- Evaluating completed contracts to determine if contract objectives have been met.

These essential elements provide the framework that enables each department to plan, monitor, and evaluate their contracts effectively.

Department Contract Planning Is Inadequate

During our review, we found that departments do not always sufficiently plan their contracts and interagency agreements to ensure that the State's best interests are preserved. In the following examples, departments did not ascertain that sufficient funding was available to complete the contracted work, specify in the written contract the contractor's required deliverables, or detail in the contract the basis for contractor payment.

In one instance, we found that the Department of Alcohol and Drug Programs (DADP) paid for services that did not satisfy the contract's original objectives. The DADP increased funding and extended a drug intervention project for one additional year even though it knew that the contractor had lost funding from other sources necessary to complete the project. During the third year of a three-year project, the DADP entered a consultant services contract that provided to the contractor supplemental funding totaling \$73,880. The DADP supplied 27 percent of the funding necessary for the consultant to implement a drug intervention program through the production of live entertainment events targeting middle and high school students. However, the other funding sources reduced their financial support during the second year and discontinued funding for the third year of the program.

In response to the decreased funding, the DADP increased its financial support by approximately \$22,000 in the second year so the program would continue. The program costs for the first

two years totaled \$277,480 and \$323,284, respectively. In the third year of this contract, the DADP approved a budget of \$73,880 for the same services that cost over \$270,000 in each of the previous years. The DADP was aware that the contractor was attempting to obtain funding from other sources. However, the DADP did not include a cancellation clause in the event the contractor was unable to obtain the additional necessary funding. Because the DADP did not require the contractor to obtain adequate funding before beginning the third year of the program, the DADP approved a budget that did not reasonably represent the program cost. When the contractor failed to obtain additional funding and could not perform all services required by the contract, the DADP changed the contract objectives and decreased the total contract amount to correspond to the work completed.

Problems with contract planning included:

- Not insuring that adequate funding was available;*
- Not specifying the required deliverables; and*
- Failing to adequately detail the basis for contractor performance and fees.*

Although we recognize that the DADP monitored the contract for the drug intervention program and limited the State's loss when the contractor could not obtain additional funding, we believe the DADP could have avoided this loss by requiring the contractor to obtain the necessary funding before beginning work. Because the services performed were limited to program planning, the DADP paid \$39,000 for services that did not satisfy the original contract objectives.

In another case, the Department of Transportation (Caltrans) entered an interagency agreement with CSU totaling approximately \$50,000 for a research and data collection project necessary to meet permit requirements. However, Caltrans failed to require a report communicating the results of this project. As a result, information collected was not submitted to Caltrans even though its primary contractor, CSU, completed the research and data collection. Because Caltrans did not require a report, it must negotiate a new agreement at additional cost to meet the permit requirements.

We also found in one instance that the Department of General Services' Office of Project Development and Management (OPDM) did not include in a contract document one essential element allowing contract managers to manage contractor performance. Specifically, in July 1990, the OPDM entered a contract with CSU for architectural consulting services. The contract and related amendments extending the contract term until 1996 did not clearly identify the basis for fees to be paid to the contractor. A failure to identify clearly in the written agreement the basis for fees to be paid can cause confusion in the management of that contract.

Adequate planning is a vital component of efficient contract management. By failing to ensure that the contracting process includes the essential contract elements, departments cannot ensure that they are using state resources efficiently and effectively.

***Departments' Management of Contracts
Does Not Always Protect the Public Interest***

We found that departments do not always adequately manage contract funds, monitor compliance with contract terms, or comply with statutory and other administrative requirements. For example, during the period of our review, some departments did not consistently recover unspent advance payments made at the beginning of the contract period, retain a portion of periodic payments as required by the contract, or obtain required approvals before contract work began.



***Departments Manage Contract
Funds Inadequately***

For 28 agreements between state departments and CSU that we reviewed, the departments entered 19 with CSU and 9 directly with campus foundations. We found that none of the agreements with campus foundations included provisions for advance payments. In contrast, for 16 of the 19 agreements, the state departments advanced payments to CSU of up to 25 percent of the contract total. For these 16 agreements, department records show advances of \$1,140,495 for contracts totaling \$7,721,607.

◆
Departments have advanced up to 25 percent of contract totals without determining the need for such advances.

In addition, we found that the contracting departments paid monthly expenses billed by CSU without offsetting these expenses against the advance payments until the end of the agreement periods. In some of these instances, CSU contracted with campus foundations that subcontracted with private consultants, but CSU retained the advance payments collected from state departments even though it did not document in the related agreement a need to receive the advances. Further, in some cases, the departments failed to recover unspent advance payments until after the contracts expired.

In one interagency agreement between CSU and the Department of Motor Vehicles (DMV), the DMV agreed to pay a 25 percent advance totaling \$126,750. The DMV paid an additional \$281,373 for expenses over a nine-month period before CSU applied expenses against the advance payment. Because, at the end of the contract period, the DMV failed to


The department did not recover unspent advances until we questioned the overpayments.


reconcile total expenses incurred by CSU to the total amounts that the DMV had paid, the DMV did not identify or recover unspent advanced funds totaling \$16,283. Further, we found that the DMV failed to identify or recover additional unexpended advances totaling \$11,190 for an earlier contract. In total, the DMV overpaid CSU \$27,473 because the DMV did not adequately monitor and recover unspent advances at the end of the agreements. After we discussed these overpayments with the DMV, the DMV requested and recovered all of the overpayments.


In a second example, the Office of Real Estate and Design Services (OREDS) of the Department of General Services (DGS) paid CSU a 25 percent advance totaling \$12,500 before obtaining contract approval. In addition, the advance remained outstanding for six and one-half months before CSU billed the department for any services. The OREDS amended the contract 10 months after the original contract was approved and paid CSU an additional \$12,500 advance representing 25 percent of the amended amount. The first advance remained outstanding for at least 19 months before CSU applied monthly expenses to the advance.

In yet another instance, CSU collected and retained an advance of \$108,500 from the DADP. The DADP entered an agreement totaling \$434,000 with CSU to develop and perform a research study. However, CSU did not provide these services; instead, CSU obtained the services of a campus foundation that subcontracted significant portions of the work to two private consultants. CSU billed the DADP for expenses and did not apply the advance until six months after the advance payment was made.


State administrative procedures allow departments to make periodic advance payments to contractors when necessary. For example, advance payments may be appropriate when the contractor incurs start-up costs or requires reasonable working capital to perform services requested by the State. We agree that this policy is reasonable as long as advance payments are not excessive. However, we believe that advances of 25 percent or more are not always warranted. Additionally, departments should liquidate advances before making additional progress payments to contractors. If advances remain outstanding for extended periods of time, the departments run the risk of payment for services that may not be rendered. Further, the longer advances remain outstanding, the more difficult these balances may be to collect.

Departments Sometimes Fail To Monitor Compliance With Contract Terms

The State Administrative Manual requires that departments ensure that they have received contractors' services before the departments pay for those services. In addition, the State Administrative Manual requires that departments monitor compliance with contract terms to ensure that the State's interests are protected. Specifically, the departmental contract manager who is responsible for approving invoices for payment should be familiar with the services provided as well as with each contract's terms. Without comparing services received to contract requirements, departments may pay contractors for services that fail to meet contract objectives.



When compliance with contract terms is not monitored, departments may pay contractors for substandard services.



During our review, we found that Caltrans and the Office of Statewide Health Planning and Development (OSHPD) did not always monitor contract payments to ensure compliance with the Public Contract Code or contracts' terms. One Public Contract Code provision specifies that departments retain 10 percent of any progress payments until the contractor completes the work satisfactorily. Contract retention is designed to protect the State's interests by ensuring that contractors complete their contractual obligation before they receive full payment. For two invoices we reviewed at Caltrans totaling approximately \$12,000 and five invoices at OSHPD totaling approximately \$38,000, the departments did not retain 10 percent of each contract payment as required by the Public Contract Code. Because Caltrans and OSHPD did not retain a portion of each payment, they needlessly increased the risk to the State associated with contractor nonperformance.

OSHPD also paid \$11,250 more for a progress payment to CSU than the interagency agreement authorized. Specifically, the agreement required OSHPD to pay 75 percent of the total contract amount to CSU upon the partial completion of the required services. However, we found that OSHPD paid approximately \$75,000, or 88 percent, for the services received rather than the \$63,750 specified by the agreement. Because OSHPD did not adequately monitor compliance with the terms of the agreement, OSHPD paid a portion of the contract too early.

Further, for 116 of 347 invoices reviewed at the eight departments we visited, we questioned whether the contractor provided sufficient detail for the amounts being claimed on the invoice. In some cases, the invoices did not sufficiently detail the services provided. In other instances, receipts for the

expenses incurred did not accompany the invoices. If department staff do not review supporting documentation for expenses, they may fail to detect inappropriate or duplicate costs.

***Departments Do Not Always Comply
With Legal and Other
Administrative Requirements***



We found that state departments do not always comply with statutory requirements for awarding and managing contracts and interagency agreements (contracts). Specifically, for the period of our review, we found that some departments failed to obtain required approvals before contractors began work, to review prior evaluations of contractors considered for new contracts, to prepare contractor evaluations within 60 days after completion of the contract, and to submit required annual reports to the DGS promptly. The areas of noncompliance for the eight state departments we reviewed appear in Table 1.

***Table 1
Noncompliance With Requirements
for Contracts and Interagency
Agreements (Contracts)***

Departments	Number of Contracts Reviewed	Dollar Amount of Contracts Reviewed	Lack of Approval Before Start of Work	No Review* of Prior Evaluation Before Contract Approval	Late Post* Evaluations	No Annual Report or Report Submitted Late
Alcohol and Drug Programs, Department of	10	\$ 3,414,957	5	2	1	1
Corrections, Department of	13	40,544,399	2	0	2	0
Employment Development Department	13	5,127,537	3	0	1	1
General Services, Department of	13	7,221,587	2	0	0	0
Motor Vehicles, Department of	13	29,930,251	3	0	2	0
Office of Statewide Health Planning and Development	10	2,605,754	5	1	2	1
Parks and Recreation, Department of	14	1,069,372	0	3	2	1
Transportation, Department of	15	18,641,090	4	3	1	1
Total	101	\$108,554,947	24	9	11	

*Requirement is applicable only for consulting contracts; 34 of the 101 contracts we reviewed were consulting contracts.

The Public Contract Code states that all contracts entered into by state agencies are void unless and until approved by the DGS. In our past four annual audit reports, we have noted state departments' failures to obtain DGS approval for contracts; nonetheless, departments continue to violate this requirement. As shown in Table 1, for 24 of the 101 contracts reviewed, the departments did not obtain required approvals before the contractors began work.


The department allowed a subcontractor to begin work before obtaining required approvals.



Furthermore, when they do not obtain required approvals before contract work begins, the departments expose the State to potential financial liability for work performed. For instance, we found that the DADP did not obtain required approvals from the United States Department of Health and Human Services (DHHS) or the DGS for one contract, which totaled \$935,500, before the DADP allowed the contractor to begin work. Specifically, the DADP entered a contract with the DHHS to conduct an alcohol and drug abuse survey, then subcontracted this work to a nonprofit organization. The contract required that the DHHS preapprove subcontractors, and, in a memorandum, the DHHS warned the DADP that expenses of subcontractors incurred before DHHS approval would not be considered for reimbursement. However, we found that the nonprofit organization performed services requested by the DADP for at least two years before the DADP obtained the required approvals from the DHHS or the DGS. As a result, the nonprofit organization incurred expenses of at least \$258,000 for services performed before contract approval. Because they did not obtain required contract approvals before the contract work began, the DADP violated its agreement with the DHHS and exposed the State to potential financial liability.

We also determined that some state departments failed to comply with state requirements that they review prior evaluations of consultant service contractors considered for new contracts and that they review resumes of persons expected to perform the work.


The California Public Contract Code and the State Administrative Manual specify that state departments are not to award consultant service contracts totaling \$5,000 or more unless they review contractor evaluations on file with the DGS and require, as part of the contract, a completed resume for each participant who will play a major role in the completion of the contract. In addition, the California Public Contract Code requires that the DGS notify departments seeking approval of proposed contracts within 10 working days of any negative evaluations in its files of a previous contract or contracts completed by this contractor. Finally, the California Public

Contract Code and the State Administrative Manual require each department to complete a post-evaluation of each consultant contract totaling \$5,000 or more within 60 days of the end of the contract. In addition, the requirements specify that the departments submit negative evaluations to the DGS.

As shown in Table 1, four of the eight departments we reviewed did not consistently comply with statutory provisions requiring that departments review contractor evaluations on file with the DGS. In addition, we found that seven of eight departments reviewed did not prepare evaluations of contractors' performance within 60 days of contract completion.



Contractor evaluations help protect the interests of the State in awarding contracts.



Evaluations help to protect the interests of the State in awarding contracts. Without reviewing negative evaluations, the departments may approve contractors that previously performed substandard work. In addition, when departments do not prepare post-evaluations that assess the contractor's performance and the contract's usefulness, the departments unnecessarily reduce the effectiveness of controls designed to protect the State's interests in awarding future contracts.

Also intended to protect the State's interests is the California Public Contract Code requirement that each state department prepare an annual report including a list of consultant contracts entered into during the fiscal year and identifying the type of bidding process. In addition, the departments must submit copies of the report within 30 working days after the end of the fiscal year to the DGS, several other state departments, and legislative committees. However, some state departments failed to comply with this requirement. For example, as shown in Table 1, five of the eight state departments we reviewed either did not submit an annual report or submitted it late. As a result, the DGS and other oversight departments cannot determine whether the number of contracts that departments award without competition is reasonable.

Conclusion

State departments do not always protect the public interest by adequately planning and managing contracts and interagency agreements. Departments are failing to ensure that all contracts and agreements contain specific language that allow the departments to monitor contractor performance and evaluate the goods or services received. Departments also allow advance payments to remain outstanding for excessive periods of time, fail to recover unspent advance payments from contractors, and fail to comply with all contract terms and

statutory requirements. If departments do not adequately plan, monitor, and evaluate their contracts, they cannot ensure that state resources are used efficiently and effectively.

Recommendations

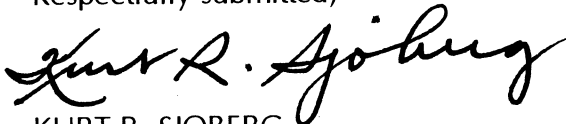
To use state funds as economically as possible, state departments should plan contracts to include all the elements necessary to monitor contractor performance and to evaluate the goods and services received.

If advance payment to contractors is necessary, state departments should make only small periodic advances. Additionally, departments should liquidate advances before making additional progress payments and recover unspent advances at the end of the contract period.

To protect the State's interests, each department should make certain that the department and its contractors comply with contract terms and any legal or administrative requirements.

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

Respectfully submitted,



KURT R. SJOBERG
State Auditor

Date: August 15, 1996

Staff: Steven Hendrickson, Audit Principal
Kim Reed, CPA
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PETE WILSON
GOVERNOR



State and Consumer Services Agency

OFFICE OF THE SECRETARY
915 Capitol Mall, Suite 200
Sacramento, CA 95814

African American Museum
Building Standards Commission
Consumer Affairs
Fair Employment & Housing
Fair Employment & Housing Commission
Franchise Tax Board
General Services
Insurance Advisor
Museum of Science & Industry
Personnel Board
Public Employees' Retirement System
State Teachers' Retirement System

August 8, 1996

Kurt R. Sjoberg, State Auditor
Bureau of State Audits
660 J Street, Suite 300
Sacramento, California 95814

Dear Mr. Sjoberg:

RE: AUDIT REPORT NO. 95015

We appreciate the opportunity to comment on your audit report entitled "State Contracting: Reforms Needed to Protect the Public Interest." Enclosed is a response from the Department of General Services (DGS) to your specific recommendations.

This Agency had been extremely supportive of the efforts undertaken by the DGS to improve the state's contracting program. Further, we are in agreement with DGS' comments regarding the potentially misleading sole source statistics contained in the draft audit report. I am hopeful you will consider the Department's concerns as you revise your draft.

Thank you for your attention to this matter and again we appreciate the opportunity to comment. If you have any questions or need additional information, please contact me at 653-2636.

Sincerely,


Joanne C. Kozberg
Agency Secretary

Enclosure

Memorandum

Date: August 8, 1996

File No.: 95015

To: Joanne C. Kozberg, Secretary
State and Consumer Services Agency
915 Capitol Mall, Room 200
Sacramento, CA 95814

From: Department of General Services
Executive Office

Subject: **RESPONSE TO BUREAU OF STATE AUDITS' REPORT NO. 95015 - STATE CONTRACTING:
REFORMS NEEDED TO PROTECT THE PUBLIC INTEREST**

Thank you for the opportunity to respond to Bureau of State Audits' (BSA) Report No. 95015 which included the review of contractual agreements entered into by offices within the Department of General Services (DGS). The following response addresses the BSA's findings related to those specific contracts. Further, where appropriate, comments are provided on the BSA's findings noted at the seven other departments which were included in the audit.

OVERVIEW OF THE REPORT

The DGS has reviewed the findings, conclusions and recommendations presented in Report No. 95015. As discussed in this response, the DGS will continue to take a strong leadership role in improving the state's contracting program.

As noted in previous reports by the BSA, the immediate responsibility for ensuring compliance in contracting for services rests with the state departments planning to be parties to the contracts. To assist state departments in complying with their responsibilities and to accomplish its oversight responsibilities, the DGS has implemented numerous administrative control activities.

Prior to discussing the actions the state has taken over the last few years to improve its contracting program, the DGS has an overall concern with the information presented in the report related to the use of sole source contracts to procure services. Specifically, we believe that the statement in the Results in Brief section of the report that "sixty-four percent of the 478 consultant contracts awarded were sole source" is misleading and does not accurately disclose the status of sole source contracting within the state. As discussed in the following paragraph, the referenced contract population includes a significant number of consultant service procurements that are statutorily exempt from advertising and competitive bidding and, therefore, were properly procured through sole sourcing. To provide any relevant meaning, exempt contracts should not be included in the sole source statistics used in the report. It should also be noted that the previously referenced statement is presented as the first highlighted finding in a series of negative exceptions noted in the audit report. This incorrectly implies that the volume of sole source consultant contracts is somehow in itself a negative reflection of the state's competitive bidding program.

Although in other sections of the report, the BSA correctly states that many of the consulting contracts met established criteria for exemption from competitive bidding, for complete

*California State Auditor's comments on this response begin on page 37.

accuracy, at a minimum, we believe that more information on the number of those contracts found to be statutorily exempt or otherwise found to be justified based on the BSA's audit tests should be presented in the report. Due to the limited timeframe provided by the BSA to respond to its draft report, we did not have the time to independently perform a complete analysis of the BSA's statistics. However, we did review the 1994/95 fiscal year consulting report submitted to the Legislature by the Department of Corrections (DOC) which is one of the eight departments included in the BSA's audit scope. This report disclosed that twenty of twenty-six consultant contracts awarded by the DOC were for legal representation which are a type of service that is statutorily exempt from advertising and competitive bidding per Public Contract Code Section 10356 (c)(6). Of the remaining six contracts, only two are indicated as sole source with the remaining four awarded based on a competitive bidding process. Further, we reviewed the consulting report submitted for the DGS and found that only 24 of 138 reported contracts were sole source. Of the 24 contracts, a large number, 17, were exempt legal representation contracts.

We also believe that the specific sample size and number of exceptions noted based on the tests of consultant contracts should be disclosed in Chapter 1 of the report. This would more accurately disclose the sole source justifications that were questioned during the audit and allow the DGS to determine if any systemic weaknesses should be addressed. In prior BSA reports, including last year's report which was issued in September 1995, the specific sample size of contracts reviewed was disclosed. In fact, it should be noted that last year's BSA report did not contain any exceptions with the sole source justifications reviewed for its sampled contracts.

In addition, we believe that the title of Chapter 1 of the report which states that departments often avoid the competitive bidding process in awarding contracts is misleading and not supported by the findings in the report. Based on the experience of DGS legal and audit staff, the great majority of state contracts are competitively bid or, if sole source, appropriately justified. The report does support that for one contract type reviewed, i.e., contracts between the eight departments and the California State University or its foundations, a high error rate was found. However, this error rate should not be used to conclude that overall these departments or others are managing their total contracting program in a manner that includes the "often" avoidance of the competitive bidding process. ②

As discussed later in this report, based on the Governor's direction, the DGS takes seriously its responsibility for ensuring that the sole source contracting process is not misused. The DGS believes that accurate and complete statistics on the state's sole source contracts will disclose that this responsibility has been successfully implemented.

Both during and subsequent to the 1994/95 fiscal year period covered by the BSA's audit, a number of significant actions have been taken to ensure that the state's contracting program better protects the public's interest. Specifically, based on direction provided by Governor Pete Wilson (Executive Order W-73-94), the DGS undertook the responsibility of drafting a comprehensive proposal to reform California's procurement process. The California Acquisition Reform Act of 1996 (CARA) which is currently under consideration by the Legislature contains the reforms proposed for the process.

CARA repeals the existing statutes governing the acquisition of technology, commodities and services and replaces them with a streamlined, common sense approach to governmental purchasing. More specifically, it streamlines and shortens the time it takes to complete an acquisition and enables state agencies to obtain the best quality and value for each tax dollar spent. CARA promotes a more competitive and cooperative partnership between the private sector and the state while ensuring ethical business practices and the public trust.

On July 19, 1996, the DGS also distributed the first edition of the State Contracting Manual (SCM). The SCM was a year in the making and represents the collective efforts of the State Contracting Advisory Network which includes some of the most knowledgeable contracting personnel in the state. The SCM is designed to serve as a toolbox to provide assistance to those engaged in contracting. It contains statutory and policy references as well as practical advice. The manual deals primarily with the types of contracts included in the BSA's audit, i.e., services, consultant services, and interagency agreements. Therefore, we believe that future audits should find additional improvement in compliance with contracting requirements.

In addition, the BSA's report presents information on sole source consultant contracts processed by eight departments during the 1994/95 fiscal year. Although concluding that many of the contracts met established criteria for exemption from competitive bidding, the BSA found that in some cases departments did not sufficiently demonstrate that sole source contracting was in the best interest of the state. Through Executive Order W-103-94, dated August 17, 1994, the governor reinforced the state's policy whereby procurements or contracts for goods and/or services are to be awarded through the use of a competitive process.

The executive order also addressed the issue of approvals of sole source procurements or contracts, and required the application of a high level of accountability in the decisions leading to such transactions. Except in cases of emergency response for the public health or safety, or for the protection of state property, such transactions must now be approved by a cabinet level Agency Secretary (Secretary) or, for those departments not reporting to a Secretary, by the organization's highest ranking official or Chief Executive Officer. The executive order was implemented through the issuance by the DGS of Management Memorandum No. 94-16 on September 15, 1994. Since the issuance of the executive order and implementing management memorandum, there has been a decrease in requests to the DGS for exemption from competitive bidding.

In summary, during and subsequent to the BSA's audit period significant actions continue to have been taken to improve the state's contracting program through the issuance of the SCM and the Governor's executive order addressing sole source contracts. Further, the proposed reforms contained in CARA will result in the further protection of the public's interest.

The following response provides our comments on each recommendation. The DGS is taking appropriate action to address the exceptions taken with a number of contracts processed by its offices that are presented in Chapter 2 of the report.

RECOMMENDATIONS

CHAPTER 1

RECOMMENDATION #1: *To ensure that exemptions from advertising and competitive bidding are in the best interest of the State, departments should request these exemptions when they can sufficiently demonstrate that only one contractor can provide the services.*

DGS RESPONSE #1: The report did not reference any DGS contracts as violating advertising and competitive bidding requirements. However, through its oversight responsibilities, the DGS reviews and approves advertising and competitive bidding exemption requests. As stated in the overview section of this response, during the period covered by the audit, the state strengthened

its requirements for justifying exemptions from advertising or competitive bidding. The DGS' Office of Procurement is enforcing these requirements and only approves an exemption after the submittal of a full and complete justification.

RECOMMENDATION #2:

The use of interagency agreements and exempt contracts should be restricted to utilizing existing public resources; such agreements should not be tools for circumventing existing state contracting practices. State departments should also use competitive bidding practices to contract directly with private parties rather than using interagency agreements and exempt contracts.

DGS RESPONSE #2:

The report did not reference any DGS contracts as circumventing contracting practices through the use of interagency agreements or exempt contracts.

The body of the report cites contracts with the California State University (CSU) system or its foundations as being used as tools for circumventing existing state contracting practices. Prior to receipt of the BSA's audit report, the DGS had already determined that contracts with universities or related foundations had been used to circumvent contracting requirements, particularly the contractor selection process, and that such arrangements resulted in an increase in the cost of procuring services. Therefore, information was greatly expanded in the new SCM on state requirements related to circumvention, interagency agreements, and contracts with universities or foundations. In fact, SCM Section 3.18 specifically addresses the BSA's concerns by stating that agreements with the CSU or its foundations cannot be used to circumvent the state's competitive bidding requirements.

RECOMMENDATION #3:

The California Legislature should consider adopting legislation prohibiting departments from misusing interagency agreements and exempt contracts to obtain contract services from nonpublic resources without employing a competitive process.

DGS RESPONSE #3:

Although DGS staff are available to work with the Legislature on this issue, the recently issued policy direction discussed above provided in the SCM appears to sufficiently address the findings of the BSA and alleviate the need for new legislation. Further, although the DGS agrees with the BSA that CARA does not specifically address the subject of using interagency agreements or other exempt contracts to circumvent the competitive bidding process, CARA does address the major cause of such circumvention. Specifically, CARA streamlines the state's contracting system and provides state agencies with needed flexibility. Thus, agencies will no longer have the incentive to access the contracting flexibility enjoyed by the universities and their foundations.

CARA also provides that the Director of the DGS shall establish policies, procedures and guidelines to implement the act. If the policy direction already disseminated through the SCM is found to be ineffective, additional actions can be taken through the use of this authority.

The creation of new legislation or the revision of CARA to address the misuse of interagency agreements and exempt contracts would appear to be premature pending a review of the success of the new policy direction provided in the SCM.

CHAPTER 2

The DGS has reviewed the errors noted in this chapter that relate to specific contracts awarded by its offices and concluded that the errors do not indicate a systemic problem; however, appropriate action has been taken to ensure the avoidance of such errors in the future. The following section contains our comments related to the findings pertaining to the DGS' contracts.

It should also be noted that the new SCM and the proposed CARA will result in improvements in the planning, processing and management of the state's contracts. The SCM stresses the need for compliance with the state's contracting requirements and provides clearer explanations of those requirements. CARA stresses the planning of acquisitions and training of those involved with the contracting process.

RECOMMENDATION #1: *To use state funds as economically as possible, state departments should plan contracts to include all the elements necessary to monitor contractor performance and evaluate the goods and services received.*

DGS RESPONSE #1: The BSA found that one of the thirteen DGS contracts reviewed did not include a necessary element. Specifically, in July 1990, the Office of Project Development and Management (OPDM) entered into a contract with the CSU for architectural services. The contract and related amendments did not clearly identify the basis of fees to be paid to the contractor.

Although not indicating a systemic weakness within the OPDM's contracting program, we agree that this contract was processed without the clear identification of the basis of fees to be paid. However, OPDM personnel approving the contractor's invoices were fully aware of the rates and costs involved. The OPDM has taken action to ensure that this error in contract preparation does not recur.

RECOMMENDATION #2: *If advance payment to contractors is necessary, state departments should make only small periodic advances. For multiple-year contracts, departments need to avoid large advances of 25 percent or more. Additionally,*

departments should liquidate advances before making additional progress payments and recover unspent advances at the end of the contract period.

DGS RESPONSE #2:

The BSA found one DGS' Office of Real Estate and Design Services contract with the CSU that had a \$12,500 advance paid prior to the contract's approval. Further, the advance was not liquidated in a timely manner. The DGS agrees that errors occurred in the handling of the advance for this contract and has taken action to improve procedures.

RECOMMENDATION #3:

To protect the State's interests, each department should ensure that the department and its contractors comply with contract terms and any legal or administrative requirements.

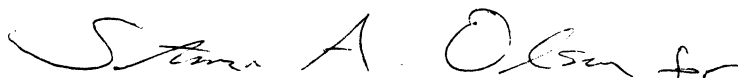
DGS RESPONSE #3:

As shown in Table 1 of the report, two of the thirteen DGS contracts reviewed by the BSA lacked appropriate approval prior to the contractor beginning work. Our review of these contracts found that they were only 11 and 14 days late and that there was no systemic problem related to the timely processing of the contracts. However, appropriate staff were made aware of the necessity of processing contracts in a timely manner.

CONCLUSION

The DGS has a firm commitment to provide efficient and effective oversight of the state's contracting program. As part of its continuing efforts to improve policies over this program, the DGS will take appropriate actions to address the issues presented in the report.

If you need further information or assistance on this issue, please call me at 445-3441.



PETER G. STAMISON, Director
Department of General Services

PGS:RG:ea:worddata:director:95015res

DEPARTMENT OF ALCOHOL AND DRUG PROGRAMS

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SACRAMENTO, CA 95814-4037
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Kurt R. Sjoberg
State Auditor
660 J Street, Suite 300
Sacramento, CA 95814

Dear Mr. Sjoberg:

This letter is in response to your August 2, 1996, draft report entitled "State Contracting: Reforms Needed To Protect the Public Interest" (Report).

Item: Departments Are Misusing Interagency Agreements and Exempt Contracts

DADP's Response: It is DADP's opinion that the interagency agreement was not misused. The training consultant mentioned in the report was and continues to be on the faculty of California State University (CSU). Therefore, DADP believed that it was appropriate to use an interagency agreement with CSU for the training consultant services. It is also important to point out that the training consultant currently has a State Master Service Agreement (MSA) (Professional and Consulting Services) with the State. DADP made plans several weeks ago to cancel the interagency agreement with CSU and plans to use the MSA in the future for these services.

3*

Item: Multiple Levels of Contract Administration Result in Excessive Costs

DADP's Response: DADP's interagency agreement with CSU authorized indirect costs at 25 percent of total direct charges. **No private organization or individual benefited from these payments of indirect costs. The indirect costs were paid to another unit of state government.** Services were provided by CSU. The only issue in this matter is, what is an appropriate level of indirect costs?

4

Item: Departments Manage Contract Funds Inadequately

DADP's Response: DADP is currently evaluating its process regarding advance payments to ensure compliance with state administrative procedures.

*California State Auditor's comments on this response begin on page 37.

Item: Departments Do Not Always Comply With Legal and Other Administrative Requirements

DADP's Response: With respect to the example for DADP cited on page 2-8 of the draft Report, DADP did not violate its agreement with the United States Department of Health and Human Services (DHHS) and the State was not exposed to a potential financial liability. The subcontract with the Western Consortium for Public Health was approved by DHHS on January 13, 1995, and was approved by the Department of General Services on April 24, 1995. The contract covered the period from April 1, 1995 through October 31, 1996, which is subsequent to DHHS approval. Western Consortium assumed the risk of performing any work prior to the execution of the contract. Per the Public Contract Code, Section 10335, a contract is of no effect (not valid and enforceable) until approved by the Department of General Services.

5

General Comments:

Specifically, regarding sole source and exempt contracts, the DADP has a policy for awarding contracts that ensures the utilization of a competitive bid process unless it can be justified that the best interests of the State are served by one specific contractor. Since State Fiscal Year (SFY) 1994-95, DADP has significantly reduced the number of interagency agreements between DADP and the California State University (CSU), the University of California (UC), the Chancellor's Office of the California Community Colleges (COCCC), and any auxiliary organizations of CSU, UC, or COCCC. Further, DADP ensures that all interagency agreements entered into with the aforementioned organizations are appropriate and are not used to circumvent the State's contracting process.

Additional efforts taken by DADP to improve its contracting process include the establishment of a DADP Contracts Manual to provide staff (contract monitors) with the tools and guidance necessary to effectively monitor the contracts for which they are responsible. The manual identifies DADP's policy as well as the specific processes surrounding the various aspects of awarding, processing, and monitoring a contract. We have also made significant strides in ensuring that contracts are approved before work is started by a contractor. In addition, we are evaluating our process regarding advance payments to ensure compliance with state administrative procedures. *With respect to the annual report on consultant contracts, it should be noted that DADP has completed the report for SFY 1995-96 and anticipates timely submission to the Legislature.*

Kurt R. Sjoberg

-3-

In summary, DADP, subsequent to the audit period, has already implemented many improvements in our contracting process and will continue to review and evaluate those processes and policies to ensure compliance with applicable laws, regulations and State policy.

If you have any questions or need additional information regarding this matter, please contact William Sweeney at (916) 323-1866.

Sincerely,

A handwritten signature in black ink, appearing to read "Andy Mecca". The signature is written in a cursive, flowing style with a large initial "A".

ANDREW M. MECCA, Dr.P.H.
Director

Comments

California State Auditor's Comments on the Responses by the State and Consumer Services Agency and the Department of Alcohol and Drug Programs

To provide clarity and perspective, we are commenting on the State and Consumer Services Agency's (agency) and the Department of Alcohol and Drug Programs' (department) responses to our audit report. The numbers correspond to the numbers we have placed in the response.

- ① To address the agency's concern that a reader of this report who did not read the full report could be misled by this statement, we removed this statement from the Executive Summary—Results in Brief portion of the report.
- ② We agree with the agency's comment that our Chapter 1 title in the draft copy of the report, "State Departments Often Avoid the Competitive Bidding Process in Awarding Contracts," could be improved. Therefore, we revised the Chapter 1 title for the final copy of the report. The title for Chapter 1 now reads "State Departments Often Avoid the Competitive Bidding Process Through the Misuse of Interagency Agreements."
- ③ On numerous occasions throughout the audit, we asked department staff and employees of the campus foundation which administered this agreement to provide evidence that the consultant was a California State University (CSU) employee. Neither the department nor the foundation could provide this evidence.
- ④ The department defends its payment of unnecessary indirect costs by pointing out that indirect costs were paid to another unit of state government. This argument misses the point. As we state on page 11, the department agreed to pay CSU for administrative services similar to those provided by department staff. We consider payment for any services that duplicate efforts of department staff to be excessive. Whether these payments were made to a private organization, an individual, or another unit of

state government is irrelevant. Because the department chose to pay for duplicated efforts, these funds were not available to provide services to the public.

- ⑤ The department's response to this issue does not address our concern. The department points out that the subcontract period started on April 1, 1995, whereas we have evidence that the subcontractor started work as early as December 1992. We have two invoices which show that the project period on the subcontract started in November 1993, not April 1, 1995. In addition, in a letter to the department dated October 1994, the U.S. Department of Health and Human Services (DHHS) expressed concern that work had begun on this subcontract even though DHHS had not yet approved the subcontract. Finally, if, as the department states in its response, the contract period began April 1, 1995, the department paid one individual more than \$60,000 in salary for the contract period between April 1, 1995, and April 10, 1995, when the first invoice was submitted by the contractor.

STATE OF CALIFORNIA

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BUSINESS, TRANSPORTATION AND HOUSING AGENCY

DEAN R. DUNPHY
Secretary

August 7, 1996

Mr. Kurt R. Sjoberg
State Auditor
660 J Street, Suite
Sacramento, CA 95814

Dear Mr. Sjoberg:

In reference to your report entitled "State Contracting: Reforms Needed to Protect the Public Interest," dated August 1996, the Business, Transportation and Housing Agency concurs with the Bureau of State Audit's findings. The Departments of Transportation and Motor Vehicles are implementing corrective measures, and will monitor and report appropriately on corrective actions taken.

Sincerely,

A handwritten signature in cursive script, appearing to read "Dean R. Dunphy".

DEAN R. DUNPHY
Secretary

Alcoholic Beverage Control
Department of State Banking
Department of Corporations
California Highway Patrol
California Housing Finance Agency

Department of Housing &
Community Development
Department of Motor Vehicles
Department of Real Estate
Office of Real Estate Appraisers

Office of Savings & Loan
Stephen P. Teale Data Center
Office of Traffic Safety
Department of Transportation (Caltrans)

DEPARTMENT OF CORRECTIONS

P.O. Box 942883
Sacramento, CA 94283-0001



August 9, 1996

Kurt R. Sjoberg
State Auditor
Bureau of State Audits
660 J Street, Suite 300
Sacramento, CA 95814

Dear Mr. Sjoberg:

This is in response to your August 2, 1996 letter regarding the draft report entitled "State Contracting: Reforms Needed to Protect the Public Interest." The following is the California Department of Corrections' (CDC) response to the issues cited in this report.

Issue:

Out of 13 contracts reviewed, 2 contracts commenced services prior to approval.

Response:

CDC firmly enforces contract compliance in regards to this issue. Unless an emergency situation exists or a legal contract necessitates an immediate start date, requests for late approval of contracts are denied. The two contracts cited are amendments to Reentry contracts. Reentry contracts are written for five years with amendments executed annually to encumber appropriate funds. Although CDC cannot justify these contracts as an emergency situation or a legal contract, a delay in service would have placed an extensive hardship on the Department. The contract office will continue to work with program staff in regards to submitting their requests in a more timely fashion.

Issue:

Of the same 13 contracts referenced above, 2 contracts did not have a completed Contract/Contractor Evaluation (Std. 4) within the required 60 days of the completion of the contract.

Response:

CDC's contract office has implemented an automated system to generate a report listing all contracts that have expired. Utilizing this report, contract staff are able to follow-up with program staff regarding their responsibility to complete and submit a Std. 4. Due to an error in the system, the contracts referenced above were not displayed on the report as expired. Subsequent follow-up with program for the first contract indicated that the contractor never performed the requested work on one of the contracts. For that reason, it was determined that no Std. 4 was necessary. However, it was later determined that two invoices had been approved. Program staff had approved the invoices believing that they represented work being done on a prior contract. Program staff have since completed the Std. 4 and it has been added to the file.

With respect to the second contract file, program was contacted, and a Std. 4 has since been completed, and added to the file. Program was informed of the importance of fulfilling their responsibility to complete and submit a Std. 4 within the required time frame. The contract office will continue to work with program staff in submitting their reports in a timely fashion.

CDC takes our responsibility to process all contracts in accordance with State policy very seriously and will continue to strive towards developing additional methods to reduce untimely submittal of contract requests and eliminate deficiencies.

If you have any questions or if you need additional information, please call James E. Tilton, Deputy Director, Administrative Services Division, CDC, at 323-4185.

Sincerely,



JAMES H. GOMEZ
Director of Corrections



Serving the People of California

CONFIDENTIAL



M E M O R A N D U M

To: Kurt R. Sjoberg, State Auditor
Bureau of State Audits, B-24
660 J Street, Suite 300
Sacramento, CA 95814

Date: August 7, 1996

File No.:

From: Employment Development Department

Subject: BUREAU OF STATE AUDITS REPORT ON STATE CONTRACTING

The Employment Development Department (EDD) welcomes the opportunity to review the Bureau of State Audits' Draft Report 95015, "State Contracting: Reforms Needed To Protect The Public Interest."

In the attached reply, we responded to the findings and recommendations pertaining to the EDD.

The EDD appreciates the cooperation of the Bureau of State Audits' staff during the course of the audit and this opportunity to respond to the draft audit findings.

If you have questions or need additional information, please contact Jack Barr, Jr., Chief of Business Operations Planning and Support Division, at 654-8299.

Victoria L. Bradshaw

VICTORIA L. BRADSHAW
Director

Attachment

cc: Tom Roberson, Health and Welfare Agency
Michael Tritz, EDD
Jack Barr, Jr., EDD

EMPLOYMENT DEVELOPMENT DEPARTMENT
RESPONSE TO THE BUREAU OF STATE AUDITS' DRAFT REPORT TITLED
"State Contracting: Reforms Needed to Protect the Public Interest"

August 7, 1996

The Employment Development Department (EDD) reviewed the Bureau of State Audits' (BSA) draft report titled "State Contracting: Reforms Needed To Protect the Public Interest." The public trust is paramount in our conduct of business; accordingly, we appreciate the report's external perspective and the opportunity for further improvements in our overall contracting performance. Additionally, we appreciate the opportunity to respond to the report's concerns and recommendations. We agree with BSA's conclusion that parts of the state's contracting process are ineffective. The EDD actively participated in a statewide contracting reform effort sponsored by the Department of General Services (DGS). We look forward to improvements in the contracting process and believe that some of the problems identified in the report will be eliminated by these process improvements.

The report concentrates largely upon possible misuse of the ability to contract with the California State University (CSU) system. As stated in your report, our CSU interagency agreements and contracts with university foundations are a legal contracting alternative which offer cost effective and efficient access to the university system's diverse array of services and resources. While this is a worthy and legitimate use of the interagency agreement process, we do seek to ensure that EDD abides by reasonable business practices as well as the State Administrative Manual and the Public Contract Code.

We believe that several innovations will nearly eliminate the types of findings that this report identifies. For example, DGS now provides more contracting alternatives which enable EDD to retain timely consultant services. These alternatives include additional master service agreements (MSA) with multiple service providers and a streamlined process for obtaining services under these MSAs. Additionally, we are able to obtain information technology consultant services through the California Multiple Awards Schedule; this relatively new process significantly reduces delays in the competitive bid and contract award processes. We expect that these new competitive methods will significantly reduce the number of sole source contracts required due to time constraints.

Furthermore, through the introduction of the new "State Contracting Manual," DGS has provided much clearer direction for processing interagency agreements than ever before. The new manual specifically requires that services provided through agreements with the University of California, California State University, and California Community Colleges, but not provided by these entities, must be obtained through a competitive bid process. Accordingly, EDD will ensure that future

contracts with these entities will include language compliant with this new requirement.

Clearly, opportunities exist to strengthen the quality and control aspects of EDD's overall contracting performance. The report identified statewide issues surrounding advance payments, contractor performance and evaluation, and invoice documentation. The EDD is focusing on a departmentwide action plan for ensuring legally compliant, efficient, cost effective, and appropriately managed interagency agreements and contracts. Our efforts include:

- Effective January 1996, negotiating reasonable administrative overhead costs in interagency agreements and exempt contracts;
- Requiring that subcontractors, used to perform a portion, or all of services rendered under an interagency agreement, are identified in writing by the state entity contracted to provide the service;
- Increasing departmental awareness of state contracting law and requirements, and educating employees in the areas of contract negotiation, monitoring, management, and financial accountability (including advance payments);
- The EDD's Contract Services Group will continue to provide customer education and emphasize the need to have an approved contract in place before a contractor may begin work. Specifically, the Contract Services Group met with each EDD branch to discuss how to plan contract request processing to ensure a final contract prior to the contract start date. However, it is important to note that EDD assumes no risk when services are provided in advance of contract approval because of standard contract provisions. Any work performed prior to an approved contract is performed at the contractor's own risk. Additional assurances are provided since our Fiscal Programs Division will not pay an invoice without an approved copy of the contract;
- The EDD's Contract Services Group implemented a new control process to ensure that consultant contract evaluations are submitted within 60 days of contract completion; and
- Additionally, we made every effort to submit the Annual Consulting Service Report within the required timeframes in past years, and will do so again. However, we believe that, considering the level of review required for a report of this nature, the 30 working day turnaround may not be reasonable. Our position is substantiated by the fact that many other departments are not meeting the deadline. We suggest that 45-60 working days is a more reasonable timeframe.

In conclusion, we believe that new contracting alternatives provided by DGS, along with specific requirements cited in the State Contracting Manual, and EDD's aggressive internal education effort will resolve deficiencies noted in the report. If you have any questions regarding this response, you may contact Jack Barr, Jr., Chief of the Business Operations Planning and Support Division at 654-8299, or Kay Overman, Manager of the Contract Services Group at 654-6834.

OFFICE OF STATEWIDE HEALTH PLANNING AND DEVELOPMENT

OFFICE OF THE DIRECTOR
1600 9th Street, Room 433
Sacramento, California 95814
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August 7, 1996

Kurt R. Sjoberg
State Auditor
Bureau of State Audits
660 J Street, Suite 300
Sacramento, California 95814

Dear Mr. Sjoberg:

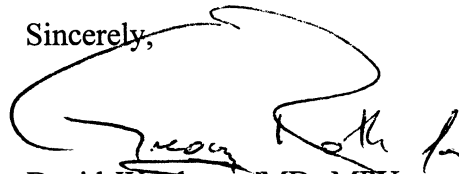
Thank you for the opportunity to review the draft report, entitled "State Contracting: Reforms Needed to Protect the Public Interest" and dated August 2, 1996. The Office of Statewide Health Planning and Development would offer the following comments.

First, the findings presented in the report with respect to this Office appear to be correct. While they point to several opportunities to improve our contract oversight processes, I am pleased to see that the State Auditor found no fundamental misuse of contracting mechanisms within the Office of Statewide Health Planning and Development.

Second, I would note that even prior to the initiation of the State Auditor's review, the Office had begun revamping its contracting practices and procedures. The audit findings presented in the report will be addressed in the revised version of the Office's Contracts Manual. This manual will be disseminated to all managers and contract administrators throughout the Office of Statewide Health Planning and Development within ninety days.

Again, I appreciate the opportunity to review and comment on the draft before its release in final form.

Sincerely,



David Werdegar, MD, MPH
Director

cc. Sandra Smoley, Secretary
Health and Welfare Agency

DEPARTMENT OF PARKS AND RECREATIONP.O. BOX 942896
SACRAMENTO, CA 94296-0001

(916) 653-8380



August 8, 1996

Kurt R. Sjoberg
State Auditor
Bureau of State Audits
660 J Street, Suite 300
Sacramento, California 95814

Dear Mr. Sjoberg:

Response to Draft Audit

Thank you for the opportunity to respond to your August 2, 1996 memorandum to Secretary Wheeler. He has asked that I relay both our comments and those specific to the Department of Parks and Recreation.

We both agree proper contracting procedures can and will be practiced in Resources Agency Departments.

Entering into Interagency Agreement with the California State University (CSU), the University of California (UC) System or Community Colleges to accomplish work that is ultimately performed by private subcontractors without substantial reason is circumvention of the State's contract process. Such contracts not only circumvent the intent of State contract law, but result in multi-tiered arrangements which add participants thus increasing the indirect cost to the State and the public we serve.

We welcome the legitimate use of the UC, CSU system or other agreements designed to be between two government agencies to gain the expertise of the staff or faculty to best use the resources of the public for a common effort.

We do not advocate the use of Interagency Agreements and exempt contracts as tools for circumventing existing State contracting practices, and I have so instructed my staff. The situation you mention in using the UC system to employ a physician rather than contracting directly with the physician and his medical group has been corrected.

I sincerely appreciate your bringing this situation to my staff's attention and assure you we will seek competitive proposals in future circumstances.

Kurt R. Sjoberg
August 8, 1996
Page Two

Please continue to work with my contracts staff and feel free to continue dialogue with Al Ross on this or other contract audits your office performs. Our doors as well as our contract books are open to you at all times.

Thank you again for the opportunity to share comment on your draft. Staff and I are looking forward to reading the final product and offer our services in any area we can be of assistance.

Sincerely,



for Donald W. Murphy
Director

cc: Douglas P. Wheeler, Secretary for Resources

cc: Members of the Legislature
Office of the Lieutenant Governor
Attorney General
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps