



UCSB Audit and Advisory Services

Internal Audit Report

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**Procurement and Contracting  
Risk Assessment & Contract Compliance Review**

January 9, 2013

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**Performed by:**  
Sam Hartline, Principal Auditor

**Approved by:**  
Robert Tarsia, Director

Report No. 08-12-0008

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AUDIT AND ADVISORY SERVICES  
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January 9, 2013

To: Jim Corkill, Director and Controller  
Business and Financial Services

Re: **Procurement and Contracting – Risk Assessment & Contract Compliance Review  
Audit Report No. 08-12-0008**

As part of the 2011-12 annual audit plan, Audit and Advisory Services conducted a review of procurement and contracting for goods and services at the University of California, Santa Barbara (UCSB). Enclosed is the audit report detailing the results of our review.

One of the purposes of this project was to conduct a risk assessment of procurement activity to inform future audit planning, including determining which types of purchases, and which specific purchase orders and procurement contracts, would be the best candidates for future compliance audits. The project also included limited compliance reviews of some of the purchase orders and contracts that the risk assessment suggested were good candidates for initial reviews.

The audit identified significant compliance issues that should be addressed by campus management. The more significant of these include the following:

- Approximately \$4 million in purchases by a department over the last five years through continued use of several expired vendor blanket purchase orders.
- The second largest dollar value of campus fiscal year 2011-12 payment transactions by purchase order were conducted through a vendor blanket purchase order that had been in place with the respective vendor for more than ten years, with no price/quality comparisons made to support the departments' periodic vendor blanket renewal requests. Approximately \$11 million in business had been conducted with the vendor since inception of the vendor blanket. This long-term vendor blanket was a cost-plus agreement that contained terms allowing the University to conduct quarterly cost verification audits of the vendor's invoices. No vendor price verification audits appeared to have been conducted since 2009.
- A business contract formed by a department with delegated contracting authority did not contain several required policy and regulatory components.

The audit also identified a number of procurement and contracting risk areas to be used to inform future audit planning.

We have included a copy of our detailed observations and management corrective actions. The management corrective actions provided indicate that each recommendation was given thoughtful consideration and that positive measures have been planned to implement the corrective actions. The cooperation and assistance provided by Purchasing and Contracts and Property personnel during the review was sincerely appreciated. If you have any questions, please feel free to contact me.

Respectfully submitted,

A handwritten signature in black ink that reads "Robert Tarsia". The signature is written in a cursive style with a long horizontal line extending from the end of the name.

Robert Tarsia  
Director  
Audit and Advisory Services

Enclosure

cc: Chancellor Henry Yang  
Associate Vice Chancellor Ron Cortez  
UCSB Audit Committee  
Sheryl Vacca, Senior Vice President and Chief Compliance and Audit Officer  
Steve Kriz, Assistant Director, Business and Financial Services  
Jacob Godfrey, Associate Director, Business and Financial Services

## **PURPOSE**

One of the purposes of this project was to conduct a risk assessment of procurement activity to inform future audit planning, including determining which types of purchases, and which specific large purchase orders and procurement contracts, would be the best candidates for future compliance audits. The project also included limited compliance reviews of some of the purchase orders and contracts that the risk assessment suggested were good candidates for initial reviews. As part of this project, we also developed data mining and analysis techniques for use in this audit and future procurement audits.

## **SCOPE, OBJECTIVES AND METHODOLOGY**

The scope of the review included campus procurement and contracting activities of the Business and Financial Services department during fiscal years 2010-11 and 2011-12. The scope was primarily limited to the Purchasing unit's processing and authorization of "high-value" purchase orders (POs), and business contracts and professional services agreements (PSAs) processed and authorized through the Contracts and Property unit.

Other campus management personnel (outside of Business and Financial Services) have delegated authority for the processing and approval of business contracts for specialized purposes relating primarily to their department or business unit operations. The processes and procedures of these ancillary contracting units were not included in the scope of this review. However, contracts and related payment transactions associated with some of these departments were included in the population of fiscal year 2011-12 business contracts and transactions analyzed.

Audit objectives included:

- Designing and completing a risk assessment of procurement activity to identify high-risk areas associated with procurement, contracting, contract administration, and vendor payment activities.
- Assessing processes, internal controls, and compliance practices related to contract administration and vendor invoice payments for a small sample of higher risk and/or high dollar POs and contracts.
- Developing data mining and analysis techniques to use in this audit and future procurement audits.

To accomplish the objectives, we:

- Obtained an understanding of University policies and procedures and external regulations related to campus procurement and contracting processes (see Table 1).
- Reviewed the Purchasing and Contracts and Property units' internal policies and practices for evaluation of department purchase requisitions and contracting service requests; sourcing and assessment of vendors and service providers; and preparation, authorization, and issuance of procurement contracts.
- Reviewed campus processes and practices related to submission of purchase requisitions and requests for business contract services, and authorization of vendor payments, as well as practices related to receiving and inspection of goods and materials ordered.
- Selected a sample of two large dollar, higher risk POs, and three large dollar, higher risk business contracts formed during fiscal year 2011-12, and performed limited audit testing to

validate our understanding of procurement and contracting procedures and controls, and to determine whether there was compliance with applicable policies, procedures, and regulations.

- Reviewed a sample of at least one vendor payment made against each PO and business contract selected for compliance with PO or contract terms and conditions.
- Reviewed other high value and/or complex procurement contracts and related payment transactions in order to better understand and analyze the associated risks.

This audit was conducted in conformance with the *International Standards for the Professional Practice of Internal Auditing*.

## **BACKGROUND**

Purchasing and Contracts and Property are two operational units of the Business and Financial Services department. They are largely responsible for coordination and oversight of campus procurement and contracting activities.

### *Purchasing*

Purchasing is responsible for achieving University procurement goals of obtaining supplies, equipment, and services at the best prices available, consistent with the quality of goods required, in a timely and efficient manner. Purchasing provides guidance to campus departments on procurement policies and practices, and prepares and authorizes all high-value POs (i.e., procurement transactions \$2,500 and above, and items restricted from purchase using the low-value order process) based on purchase requisitions authorized and submitted by campus departments. The following are highlights of Purchasing operations:

- Purchases made by PO generally include equipment/machinery, computers/electronics, appliances, furniture, copiers and printing services, gases and other research supplies/materials, fabricated goods, and transportation charters.
- Items restricted from the low-value purchase method that require a PO and specialized approval, regardless of value, include controlled substances, radioactive/hazardous materials, biohazardous agents, certain compressed/toxic gases, and firearms/ammunition.
- One-time orders and vendor blanket orders are the basic types of POs. Vendor blanket orders are established for purchases of goods/services from the same vendor over a specified period of time, and are routinely extended for a period of one year if requested by the department. If a renewal is requested after the two-year extension, Purchasing may decide that a new requisition is required due to price changes or other reasons.
- University policy and California law generally require a price evaluation among competing vendors for purchases of \$100,000 and above, with the vendor sourcing based on either lowest responsible bidder or the lowest cost per quality point evaluation method. A sole source justification explaining why other vendors offering the same goods/services are unacceptable is required for purchases \$100,000 and over that are not competitively evaluated.
- The University's Strategic Sourcing Program provides campuses the opportunity to use specific vendors with negotiated pricing through planned quantity purchasing, with the goal of providing the maximum possible economic advantage.
- Business and Financial Services is currently devoting significant staff resources towards campus implementation of UCSB Procurement Gateway, an e-procurement system, to automate campus procurement activities. Gateway will provide access to a variety of contracted and non-catalog suppliers, and will serve as the order placement, authorization, and purchase order generation system for both low-value and high-value purchases.

### *Contracts and Property*

Contracts and Property prepares and authorizes PSAs and other types of business contracts for specialized services and materials, including agreements for the lease of grounds/buildings and other real estate transactions; lodging and catering; software licensing; photography/film permits; and miscellaneous services. Contracts and Property also provides guidance to campus departments on business contracting policies and practices. The following are highlights of Contracts and Property operations:

- Services are requested by departments via contract services requests that include a description of the services/materials needed; scope of work and general terms/conditions; suggested vendor(s); and management and/or control point authorization.
- Contracts and Property analyzes department requests and develops an appropriate contract; if a vendor-supplied agreement is submitted, the unit ensures that required policy and regulatory terms and conditions (and other elements) are included.
- Contracts and Property coordinates review and authorization of the finalized agreement by the appropriate department authority, the service provider, and campus management with delegated authority for approval of business contracts.
- Management personnel in a number of other campus departments/units have been delegated authority for approval of campus agreements for certain specialized services. Although Contracts and Property may provide contracting and related guidance to these departments, the contracts generated by the departments are not required to go through Contracts and Property for review and authorization. Examples include:
  - The Contracts unit in Design and Construction Services (DCS) processes all contracts related to campus construction projects.
  - The Sponsored Projects office in the Office of Research processes contracts, grants, and subagreements related to campus research projects.
  - Arts and Lectures prepares and authorizes agreements with performing artists and speakers hired as a part of its annual programs.
  - Communications Services processes agreements and licensing related to campus phone, cable TV, and internet services, and supporting equipment and infrastructure.
  - University Center (UCen) has historically processed agreements related to business operations of the UCen and Events Center.
  - The Conference Services unit in Housing and Residential Services processes agreements related to campus conferences and events the unit coordinates.
  - University Library prepares and authorizes contracts related to the purchase of books and periodicals for the Library.

Table 2 includes summary financial information related to fiscal year 2011-12 campus procurement and contracting activity, including stratification of procurement dollars by PO and business contracts into various risk categories.

<b>Table 1</b>		<b>Major Policies, Procedures, and Regulations Applicable to Procurement Contracting</b>	
<b>University of California</b>			
BFB BUS-43		Materiel Management	
BFB BUS-34		Securing the Services of Independent Consultants	
BFB BUS-77		Independent Contractor Guidelines	
University Guidelines		Contracting for Services (September 4, 2002)	
Presidential Policy		Employee – Vendor Relationships (August 19, 1982)	
Presidential Policy		Interim Administrative Guidelines to Ensure Equal Opportunity in University Business Contracting (January 1, 1996)	
UC Regents Bylaw 5.1		Composition and Powers of the Corporation	
UC Regents Standing Order 100.4		Duties of the President of the University	
<b>State of California</b>			
Public Contract Code Chapter 2.1		University of California Competitive Bidding	
<b>Federal</b>			
FFATA Subaward Reporting System		Federal Funding Accountability & Transparency Act (FFATA)	
U.S. General Services Administration		Federal Acquisition Regulations (FAR)	
OMB Circular A-110 (2 CFR, Part 215)		Uniform Administrative Requirements for Grants and Other Agreements with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations - Appendix A: Contract Provisions	

Source: Auditor Analysis

## SUMMARY OPINION

The audit identified significant compliance issues that should be addressed by campus management. The more significant of these include the following:

- Approximately \$4 million in purchases were made by a department over the last five years through continued use of several expired vendor blanket purchase orders.
- The second largest dollar value of campus fiscal year 2011-12 payment transactions by purchase order were conducted through a vendor blanket purchase order that had been in place with the respective vendor for more than ten years, with no price/quality comparisons made to support the departments' periodic vendor blanket renewal requests. Approximately \$11 million in business had been conducted with the vendor since inception of the vendor blanket. This long-term vendor blanket was a cost-plus agreement that contained terms allowing the University to conduct quarterly cost verification audits of the vendor's invoices. No vendor price verification audits appeared to have been conducted since 2009.
- A business contract formed by a department with delegated contracting authority did not contain several required policy and regulatory components.

The audit also identified a number of procurement and contracting risk areas to be used to inform future audit planning.

Audit observations and management corrective actions are detailed in the remainder of the audit report.

**DETAILED OBSERVATIONS AND MANAGEMENT CORRECTIVE ACTIONS**

**A. Procurement and Contracting Risk Assessment Results**

We obtained campus fiscal year 2011-12 PO and business contract transactions data from the UCSB Data Warehouse<sup>1</sup> and analyzed the data within various operational risk categories, including largest dollar POs/contracts; vendors and departments with largest transaction dollars; and largest transaction dollars by account, account group, fund, payment method, and other characteristics. Table 2 summarizes the data for PO and business contract transactions separately, and lists the top 3 results for each of several operational risk categories.

We analyzed the results to identify significant operational risk areas to use in developing the focus and objectives for future procurement and contracting audits. Some of the more significant risk areas identified included the following<sup>2</sup>:

*Purchase Order Risk Focus Areas*

- Approximately \$15.6 million was expended from research accounts through POs during fiscal year 2011-12. These were the largest expenditures by PO among the major account groups, representing 28% of fiscal year 2011-12 expenditures under POs. Risk areas for research funds largely relate to the extensive compliance requirements facing the University, including federal, state, and other regulations, and the negative publicity and erosion of public trust if an adequate compliance program is not enforced or achieved. Audit objectives for procurement reviews in this area would include determining whether department contracting activities include appropriate controls to ensure compliance with applicable requirements.
- Equipment-related expenditures (e.g., inventorial/non-inventorial equipment, machinery purchases, repairs/maintenance, equipment rentals, and fabrications) represented \$20.5 million, or approximately 37%, of fiscal year 2011-12 expenditures under POs, the largest among major object groups. Audit objectives for procurement reviews in this area would include determining whether operational controls related to purchase authorization, funding, receiving, tracking, use, title transfer, and disposal of equipment/machinery are in place and operating effectively.
- \$4.3 million in expenditures for student housing and food supplies/services represented 34% of POs with transactions exceeding \$250,000. Significant operational risk areas include purchase of inferior/overpriced products, theft, misuse, spoilage, and compromise of student, personnel, and community safety and trust. Objectives of procurement reviews in this area would include ensuring that supplier analysis/sourcing is sufficiently performed, controls over product receiving/inventorying and storage/preparation are adequate, and the use of funds is in compliance with housing bond covenant and other restrictions.

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<sup>1</sup> The UCSB Data Warehouse is a repository of University financial/other data from several campus transaction systems (general ledger, payroll, budget, equipment).

<sup>2</sup> The potential audit objectives for future procurement audits include the review of practices and controls at campus departments outside the operational responsibility of Business and Financial Services.

UCSB Audit and Advisory Services  
Procurement and Contracting – Risk Assessment & Contract Compliance Review

<b>Table 2 FY 2011-12 Procurement and Contracting Risk Assessment Highlights</b>	
<b>High-Value Purchase Orders</b>	
<b>FY 2011-12 Total Campus Transaction Dollars</b>	<b>\$55,709,335</b>
<u>Largest Transaction Dollars by Department</u>	
1) Housing & Residential Services <sup>1</sup>	\$9.53 million (17%)
2) Electrical & Computer Engineering	\$6.41 million (12%)
3) Student Health	\$3.67 million (7%)
<u>Largest Transaction Dollars by Vendor/Commodity</u>	
1) Cardinal Health – Pharmaceuticals and Medical Supplies	\$2.58 million (5%)
2) Jordanos – Grocery/Food Supplies	\$2.38 million (4%)
3) Agilent Technologies – Chemical Analysis Services	\$1.24 million (2%)
<u>Largest Transaction Dollars by Object Code</u>	
1) 9000 – Equipment-Inventorial	\$11.31 million (20%)
2) 8000 – Supplies/Materials	\$10.65 million (19%)
3) 7200 – Miscellaneous Service Fees	\$4.37 million (8%)
<u>Largest Transaction Dollars by Fund(s)</u>	
1) 70000 – Sales/Services-Auxiliary Enterprises	\$7.99 million (14%)
2) 19900/19941 – State General Funds	\$6.63 million (12%)
3) 66510 – Other Sources/Other (Student Health & SIS&T)	\$3.49 million (6%)
<b>Business Contracts/PSAs</b>	
<b>FY 2011-12 Total Campus Transaction Dollars <sup>2</sup></b>	<b>\$9,931,468</b>
<u>Largest Transaction Dollars by Department</u>	
1) Arts & Lectures	\$2.04 million (21%)
2) Student Information Systems & Technology	\$1.06 million (11%)
3) Budget & Planning	\$0.59 million (6%)
<u>Largest Transaction Dollars by Vendor/Service</u>	
1) Ateras – IT-Legacy Systems Migration/Modernization Services	\$0.61 million (6%)
2) Towbes Group – Real Estate Development Services	\$0.51 million (5%)
3) Balboa Building – Office Space Rental for NCEAS	\$0.42 million (4%)
<u>Largest Transaction Dollars by Object Code</u>	
1) 7235 – Consultant Fees	\$2.73 million (27%)
2) 7240 – Performance Fees	\$1.61 million (16%)
3) 7200/7201 – Miscellaneous Service Fees	\$1.58 million (16%)
<u>Largest Transaction Dollars by Fund(s)</u>	
1) 60010 – Sales/Services-Educational Activities	\$1.92 million (19%)
2) 19900/19941 – State General Funds	\$1.66 million (17%)
3) 21494/22646 – Research-U.S. Agencies-NSF/DI	\$0.81 million (8%)

Source: Auditor Analysis

<sup>1</sup> Includes all Housing & Residential Services financial/departments codes with PO expenditures greater than \$1 million.

<sup>2</sup> All payment transactions with a "CT" (contract) reference code. Includes contracts processed through Contracts & Property, and transactions related to contracts developed by other campus departments with business contracting authority that also use the CT reference code. This amount does not include contracts that generate revenue.

- \$2.6 million in expenditures for pharmaceuticals and medical supplies comprised the second largest category of POs with transactions exceeding \$250,000 (20%). Objectives of procurement reviews in this area would include determining whether adequate supplier analysis/sourcing procedures are in place; ordering/authorization and receiving/inventorying/tracking processes are providing sufficient control; drug security practices are acceptable; and drug issuance is performed in compliance with applicable laws and policies.
- PO expenditures from State general funds (\$6.6 million) represented the second largest category of fund sources for PO transactions (12%). Primary objectives of procurement reviews in this area would include determining whether there are practices in place to ensure compliance with fund restrictions.

*Business Contract Risk Focus Areas*

- Approximately 20% of fiscal year 2011-12 expenditures through professional services contracts (\$2 million) were related to performance events (e.g., payment of artist/speaker fees, travel, and accommodations). This service-related risk area represented the largest dollar contract expenditures among departments and fund groups. The department with the largest dollar volume of performing artist expenditures creates, authorizes, and issues its own PSAs. Contractual risks include inadequate department knowledge regarding business contracting policies and/or omission of legally required contracting elements in department-drafted contracts.
- The second largest group of professional services contracts (8%) included \$766 thousand in contracts to procure IT programming and system design services related to the Student Information Systems Modernization Project. An increase in campus expenditures for IT services is expected due to ongoing replacement and modernization initiatives for all major student and financial systems. Future audit focus in this area would include determining whether contracting practices ensure that liability for data loss/exposure and systems downtime is appropriately addressed, and that there are appropriate processes to comply with University systems development and data security policies.
- Agreements with independent contractors comprised 60% (approximately \$6 million) of all fiscal year 2011-12 business contracts. Primary risks include misclassification of service providers that could result in significant IRS fines/penalties. An objective of future contracting reviews in this area would be to ensure that independent contractor vs. employee classification factors are sufficiently analyzed as part of the procurement and contracting process.
- Approximately \$1.94 million in expenditures under business contracts were made from research accounts during fiscal year 2011-12, the second largest (20%) among the major account groups. Business contracting risk and focus areas for research funds are the same as for POs, described above.
- Approximately 15% of business contract expenditures (\$1.5 million) related to the rental and lease of off-campus facilities for business purposes and events. Future audit coverage would include assessment of contractual measures for mitigating risks related to inadequate insurance coverage, insufficient health measures, and lack of justification for choice of external providers that displace the use of campus departments and personnel providing the same or similar services.
- \$1.7 million in expenditures from State general funds comprised the second largest category of fund sources for business contract transactions (17%). Risks and future audit focus areas are the same as for POs, described above.

An additional observation that should be brought to management's attention relates to invoice payment methods. Approximately 91% of all vendor invoices under PO and approximately 88% of all vendor invoices under business contracts for fiscal year 2011-12 were paid by physical check; only 8% of POs and 4% of contracts were paid using less risky and less costly electronic payment methods. It is our understanding that this issue will be addressed as campus implements new e-procurement and financial systems.

**B. Improvements Needed in Purchase Order Compliance**

The audit identified some practices that may not result in the most cost-effective procurement:

- The second largest purchase order under which purchases were made during fiscal year 2011-12 expired on December 31, 2010, without being extended, and the department was continuing to conduct purchases with the vendor using the expired vendor blanket authorization. The original order pricing, effective September 1, 2000, was based on an 8% mark-up on the vendor's invoice cost for grocery and food supplies, and pricing terms did not appear to have changed since 2000. Order terms included a condition that the University "reserves the right to inspect and verify the landed cost prices by auditing the vendor's invoices and books on a quarterly basis...to assure contract compliance." However, it did not appear that the department had performed an audit of the vendor's pricing since 2009.
- We reviewed several additional large vendor blanket orders with food suppliers for the same department, and found two additional expired vendor blankets that were being used. One of the orders had expired in 2007. The value of purchases made by the department against the expired agreements, from expiration date through August 31, 2012, totaled almost \$4 million.

Approximately \$11 million in purchase transactions were conducted with the long-term food supply vendor referred to above, from January 1, 2000, through August 31, 2012. Also, for at least 3 years, periodic price and quality comparisons did not appear to have been made to ensure that all purchases were the most cost-effective and that University procurement and contracting goals were met.

**C. Improvements Also Needed for Business Contracts**

Significant procurement and contracting risks appear to exist in departments that have been delegated contracting authority, but may not have adequate compliance assurance measures in place over their contracting activities. For example, contractual elements for professional services contracts required by University policy and State law were either not included in, or had been stricken from, the contract by the contracting department when developing an \$85,000 agreement through a delegation of authority for contracts specific to the department's performing artist/speaker programs. Signature approval of the contract by both the service provider and department director was not dated, and contract terms describing policy-required vendor liability insurance had been stricken from the contract, apparently prior to authorization. Also, hand-written adjustments had been made to the contract verbiage without clear indication of approval by both authorizing parties. The department had the largest dollar value (approximately \$2 million) of business contract payments during fiscal year 2011-12.

To ensure that purchasing and contracting processes are well-controlled and administratively sound, Business and Financial Services should:

- Enhance campus-wide controls that help achieve University procurement goals and foster adherence to applicable policies and regulations.
- Ensure that department personnel with purchasing and delegated contracting authority responsibilities receive adequate training that covers all compliance requirements and other procurement and contracting essentials related to their operations and the professional fields of their service providers.
- Take steps to ensure that vendor payments are supported by appropriately authorized and current purchase agreements.
- Determine whether non-centralized purchasing systems and practices delegated to certain campus departments are providing appropriate controls.
- Ensure that the departments have access to standardized or “master” agreement templates that include the contract elements required for their specialized professional service categories.

### **Management Corrective Actions**

We agree with the audit recommendations. Business and Financial Services is currently assessing the additional resources needed to continue to improve critical campus procurement processes. In conjunction with this effort, we will draft and implement a corrective action plan that includes:

- Tasking the new Associate Director of Internal Controls with review and assessment of delegated campus procurement processes, to ensure that there are sufficient controls in place to protect the University’s interests and foster compliance with applicable policies.
- Reviewing and enhancing select campus-wide controls to ensure that they are adequate, including a focus on non-centralized purchasing systems and practices delegated to certain campus departments.
- Ensuring that department personnel with purchasing and delegated contracting authority responsibilities receive adequate training. (We may request that Audit and Advisory Services assist in this effort by presenting the results of this audit and the potential impact to UCSB.)
- Taking steps to ensure that vendor payments are supported by appropriately authorized and current purchase agreements.
- Ensuring that departments have access to standardized or “master” agreement templates that include the contract elements required for their specialized professional service categories.

The corrective action plan will be completed by July 31, 2013.