

The State Inspector General (SIG) began operations in August 2012 under State statute as an independent agency to conduct unbiased fraud, waste, and abuse investigations in the operations of the Executive Branch. A legislative mandate in the SIG's mission is to pass "lessons learned" from our investigations and management reviews to all state agencies to stimulate Agency Heads to reflect on how their respective agencies may handle similar issues, which at a minimum is a soft quality control and at its best, inspires positive change. The following is the SIG's seventh "Lessons Learned Alert."

SIG Lessons Learned Alert No. 7: Vendor Contracts with Rebate Terms

The SIG conducted a review of a university's contracts with major vendors requiring, as part of the contract, specific revenue, rebates, or capital projects be provided to the university. Lessons learned are equally applicable to all state agencies.

In some of these vendor contracts, vendor revenue or rebates went to third parties, specifically foundations associated with the university. Regardless of the nexus these foundation expenditures had in supporting the university, the issue was any consideration from a vendor contract with the university belonged to the university, a state agency, not a foundation. The Budget and Control Board, Procurement Services Division, concurred with this analysis. The diversion of these funds removed transparency in the expenditure of these funds, as well as allowed the use to be determined without competing in the normal university budgetary framework with other university business needs. Further, in the very best possible light, these foundation expenditures with vendor funds fell into the category of "nice to have" benefits, many of which were inconsistent with how the public, appropriators, and state procurement policy envision state funds being spent.

A secondary "lesson learned" emerged as the SIG also questioned aspects of vendor contracts with rebates going directly back to the university. Monetary rebates are certainly reasonable if directly connected to a profit sharing revenue stream or commissions to incentivize vendors' productivity. Additionally, capital improvement rebates with a sufficient nexus to services provided, such as refurbishing a dining hall in a food service contract, may facilitate passing costs onto students as an appropriate user type fee. However, many rebates are not much more than creative financing to create dollars or special projects, many having a "nice to have" quality or create an opportunity for parochial projects. These types of rebates undermine transparency, accountability, and managing contract performance in the following areas:

- Creates potential conflicts of interests undermining rigorous contract monitoring by a state agency. As one experienced Board member commented on these rebate contract requirements, 'why would I be forceful with a vendor if I'm getting something on the backend? I am going to do a whole lot of tolerating.' As an example, one vendor contract included a \$200,000 unrestricted "partnership gift" on the first day of the contract.
- Creates hidden costs to consumers. In the SIG's review, students paid hundreds of dollars extra to support a vendor's lump sum monetary contributions back to the university.
- Rebate funded special projects can create a "pre-selection" inhibiting the normal comparative scrutiny projects should receive in the agency, or even legislative, budgetary processes. The agency component sponsoring a contract can build in rebate requirements for a parochial project, which has a value much less than other agency needs. This parochial project gets funded by creating this manufactured revenue stream outside of the normal budget process.

The direction for the future should be to get back to fundamental management in these types of unnecessarily rebate laden vendor contracts, with emphasis on transparency and simplicity. The simple analysis is to get rid of the clutter and confusion from those unnecessary rebates to focus on the contract's measurable performance, simplify agency contract monitoring to ensure value received, and reduce distractions impacting either.

Recommendations:

- 1) Agency Heads should ensure agency contracts with revenue or rebates are directed to the agency and not to a third party, such as a foundation, unless expressly authorized by law.
- 2) Agency Heads should skeptically view fee for service contracts with rebates.
- 3) Agency Heads should emphasize that revenue contract funds should optimally come back to the agency's general or unrestricted funds in a systematic recurring manner, and any form of rebate, often lump sums or capital expenditures, should be viewed skeptically to avoid parochially moving contract funds away from the agency's general needs.