



STATE OF NORTH CAROLINA

PERFORMANCE AUDIT

**OFFICE SUPPLIES TERM CONTRACT ADMINISTERED
BY THE DIVISION OF PURCHASE AND CONTRACT**

DEPARTMENT OF ADMINISTRATION

SEPTEMBER 2008

**OFFICE OF THE STATE AUDITOR
LESLIE W. MERRITT, JR., CPA, CFP
STATE AUDITOR**

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Leslie W. Merritt, Jr., CPA, CFP
State Auditor

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September 9, 2008

The Honorable Michael F. Easley, Governor
Members of the North Carolina General Assembly
Mr. Britt Cobb, Secretary, Department of Administration

Ladies and Gentlemen:

We are pleased to submit this performance audit titled *Office Supplies Term Contract Administered by the Division of Purchase and Contract*. The audit objectives were to determine whether the vendor complied with the contract terms, whether the contract terms protected the interest of the State, and whether the Division of Purchase and Contract effectively monitored the contract. James D. Staton, State Purchasing Officer, has reviewed a draft copy of this report. His written comments are included in the appendix.

The State Auditor initiated this audit to identify improvement opportunities in state contract administration.

We wish to express our appreciation to the staff of the Division of Purchase and Contract at the Department of Administration for the courtesy, cooperation, and assistance provided us during the audit.

Respectfully submitted,

A handwritten signature in cursive script that reads "Leslie W. Merritt, Jr.".

Leslie W. Merritt, Jr., CPA, CFP
State Auditor

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PERFORMANCE AUDIT

SUMMARY

PURPOSE

This audit report evaluates Office Depot's compliance with, and the Division of Purchase and Contract's (P&C) administration of, the statewide term contract for general office supplies (term contract number 615A) and makes recommendations so P&C management can take appropriate corrective action.

RESULTS

Office Depot violated the terms of the statewide office supplies term contract and overcharged state agencies approximately \$294,413. The vendor inflated retail prices for its store brand products and failed to offer the State the lowest available prices as required by the contract. Without written authorization, the vendor also added items to the online catalog that were already available to state agencies on other statewide term contracts. State agencies unknowingly purchased the unauthorized items from Office Depot in violation of North Carolina Administration Code (01 NCAC 05B.1101) that, with a few exceptions, prohibits agencies from purchasing commodities or services covered by a statewide term contract from any source other than the vendor or vendors who are awarded the contract.

P&C used contract terms and conditions that allowed the vendor to exploit the contract to the vendor's advantage. Contract terms allowed Office Depot to control product identification numbers and use that control to discontinue contracted items or make them unavailable for purchase. The contract also contained unclear product category descriptions that allowed the vendor to control the discount an item received. Finally, the contract did not contain clear penalties for poor vendor performance. As a result of these contract weaknesses, state agencies paid higher prices than those specified in the contract.

Although P&C monitored the contract and resolved hundreds of pricing errors identified by P&C and state agencies, the monitoring procedures did not ensure vendor compliance with the statewide office supplies term contract. Procedural weaknesses included no automated contract monitoring procedures, no automated tracking of user complaints, and no formal training for employees who monitor contracts. Consequently, P&C did not identify vendor changes to the online catalog in a timely manner or ensure that those changes complied with the contract. P&C was also limited in its ability to efficiently and effectively track the resolution of state agency complaints.

RECOMMENDATIONS

P&C should pursue collection of overcharges state agencies incurred on purchases from the online catalog. P&C should review the vendor's performance and determine if it is in default of contract. If P&C finds the vendor in default of contract, P&C should terminate the contract and consider debarring Office Depot from doing business with state agencies.

P&C should ensure that future online catalog contracts identify items by product identification numbers that the vendor cannot manipulate, clearly define product categories, and provide a method to penalize vendors for poor performance.

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P&C should automate its contract monitoring and complaint tracking procedures to better ensure vendor compliance with the statewide office supplies term contract. P&C should identify position requisites and implement training for contract monitoring positions.

DEPARTMENT'S RESPONSE

The Department's response is included in the appendix.

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INTRODUCTION

BACKGROUND

In December of 2006, the Division of Purchase and Contract (P&C) at the Department of Administration awarded a two-year statewide term contract for office supplies to Office Depot (term contract number 615A). P&C uses statewide term contracts to consolidate state agency purchasing requirements into one or a small number of agreements by establishing authorized suppliers and prices for commodities and services. P&C contracted with Office Depot based on the vendor's bid to save state agencies approximately 71 percent of the retail price on general office supplies.

State agencies purchase items from the Office Depot punch-out catalog. A punch-out catalog is a vendor-controlled web-based catalog that state agencies access from the North Carolina E-Procurement system by "punching out" to the vendor's website. P&C contract administrators are responsible for monitoring the statewide term contract. Contract administrators enforce the contract's terms and conditions, including price and availability. Enforcing contract terms and conditions is important because North Carolina Administration Code (01 NCAC 05B.1101), with a few exceptions, prohibits agencies from purchasing commodities or services covered by a statewide term contract from any source other than the vendor or vendors who are awarded the contract.

The dates of the current statewide office supplies term contract are from December 7, 2006, to December 7, 2008. The contract includes general office supplies, toner, inkjet and fax cartridges, and limited quantities of printer and copier paper. State agencies purchased \$2,719,506 of office supplies from the Office Depot punch-out catalog during the six-month period from July 1, 2007, to December 31, 2007.

OBJECTIVES, SCOPE, AND METHODOLOGY

The audit objectives were to determine whether the vendor complied with the contract terms, whether the contract terms protected the interests of the State, and whether the Division of Purchase and Contract (P&C) effectively monitored the contract.

The State Auditor initiated this audit to identify improvement opportunities in state contract administration.

The audit scope included state agency purchases on statewide office supply term contract number 615A from July 1, 2007, to December 31, 2007. We conducted field work from February 25, 2008, to May 27, 2008.

To determine whether the vendor complied with the contract terms, we compared the prices that state agencies paid to the prices stated in the contract. We also compared prices that state agencies paid to prices available to the general public on the vendor's website to determine if state agencies received the lowest available prices.

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To determine whether contract terms protected the interests of the State, we analyzed the terms included in the invitation-for-bid, the contract, and related contract addenda. We compared the contract terms to contracting best practices we identified in the publication *Best Practices in Contracting for Services* from the National State Auditors Association. Although the vendor sells commodities (office supplies), the vendor is also responsible for providing related services such as posting authorized products at the right prices and ensuring that only contracted products are available for purchase by state agencies. The services provided by the vendor in the punch-out catalog are inseparable from the purchase of the commodities. Therefore, we believe the best practices identified in the publication are applicable to the statewide office supplies term contract.

To determine whether P&C effectively monitored the contract, we interviewed P&C management and contract administrators. We reviewed P&C contract monitoring procedures. We reviewed position descriptions, performance evaluations, and available training for P&C contract administrators.

Because of the test nature and other inherent limitations of an audit, together with limitations of any system of internal and management controls, this audit would not necessarily disclose all performance weaknesses or lack of compliance.

We conducted this performance audit according to generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence that provides a reasonable basis for findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We conducted this audit under the authority vested in the State Auditor of North Carolina by *North Carolina General Statute 147.64*.

FINDINGS AND RECOMMENDATIONS

1. OFFICE DEPOT VIOLATED THE CONTRACT AND OVERCHARGED \$294,413

Office Depot violated the terms of the state office supplies contract by inflating retail prices for Office Depot brand products and adding unauthorized items to the punch-out catalog. Through these two contract violations and numerous miscellaneous pricing errors, Office Depot overcharged state agencies approximately \$294,413.

Office Depot Listed Inflated Retail Prices

Office Depot violated the statewide office supply term contract and overcharged state agencies by listing inflated retail prices for its private brand items in the punch-out catalog.

Office Depot maintains two retail prices for its private brand items, one price on their online retail website and a much higher retail price on the punch-out catalog. Office Depot inflated its usual retail price in the punch-out catalog and offered the State a 71% discount off of the inflated price. As a result, state agencies can purchase some items at lower cost through the Office Depot retail website with no discount than they can through the punch-out catalog with the 71% discount.

The contract requires Office Depot to sell contracted items at the lowest available price. The contract's best pricing clause states:

“During the Contract term, if P&C or users become aware of better pricing offered by the Contractor for substantially the same or a smaller quantity of a product outside the Contract, but upon the same or similar terms of the Contract, the price under the Contract shall be immediately reduced to the lower price.”

Nevertheless, Office Depot made the same or similar items available to the general public at lower prices than the prices charged to state agencies under the contract.

Through the use of inflated retail pricing, Office Depot overcharged state agencies approximately \$72,596 on Office Depot private brand products during the six-month period from July 1, 2007, to December 31, 2007. For example, Office Depot white wove envelopes #10 were available to the general public for \$5.99 on the Office Depot retail website. State agencies purchased the same envelopes from the punch-out catalog for \$12.97 (117% overcharge). Also, the general public could purchase Office Depot bubble packing material online for \$5.29. State agencies purchased the bubble packing material for \$10.38 (96.2% overcharge). As a third example, the general public could purchase Office Depot super white multipurpose paper online for \$44.49 per case. State agencies purchased the same paper for \$82.50 (85.4% overcharge). Overall, overcharges to state agencies ranged from 4% to 117% due to Office Depot's use of inflated retail prices in the punch-out catalog.

The practice of using fictitious pricing to show large discounts in product advertising is so deceptive that the Federal Trade Commission (FTC) has commented on it. The *FTC Guides Against Deceptive Pricing* states:

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“One of the most commonly used forms of bargain advertising is to offer a reduction from the advertiser's own former price for an article. If the former price is the actual, bona fide price at which the article was offered to the public on a regular basis for a reasonably substantial period of time, it provides a legitimate basis for the advertising of a price comparison. Where the former price is genuine, the bargain being advertised is a true one. If, on the other hand, the former price being advertised is not bona fide but fictitious -- for example, where an artificial, inflated price was established for the purpose of enabling the subsequent offer of a large reduction -- the ‘bargain’ being advertised is a false one; the purchaser is not receiving the unusual value he expects. In such a case, the ‘reduced’ price is, in reality, probably just the seller's regular price.”

Office Depot Added Unauthorized Items

Office Depot also violated the statewide office supply term contract by adding unauthorized items to the punch-out catalog. The unauthorized additions resulted in overcharges because the vendor added some items to the punch-out catalog at the wrong discount amount, and some items were available for lower prices on other statewide term contracts.

The contract prohibits Office Depot from adding items to the punch-out catalog. The contract states:

“The Contractor shall make only the products awarded under this contract ...available for purchase from the punch-out catalog. Products not awarded under this contract may be blocked from the punch-out catalog or may be displayed on the site, but the Contractor shall clearly indicate within the catalog which items are contract versus non-contract. In addition, the punch-out catalog shall not allow a user to add non-contract items to a shopping cart.”

However, Office Depot added 24,284 items from what Office Depot calls their “web assortment” to the punch-out catalog on March 5, 2007. The Division of Purchase and Contract (P&C) did not authorize the additions and did not discover them until 10 months later, on January 16, 2008. Office Depot did not remove the web assortment from the punch-out catalog until March 14, 2008, a full year after the vendor added the items. During the six-month period from July 1, 2007, to December 31, 2007, state agencies purchased 12,972 web assortment items totaling \$215,079 and were overcharged approximately \$82,064.

Some overcharges occurred because Office Depot added the web assortment items to the punch-out catalog at incorrect or no discounts. For example, state agencies received no discount and paid \$17.99 for each “Webster’s Desk Set” from the web assortment. State agencies should have received a 71% discount and only paid \$5.22. As a result, state agencies were overcharged 245%. State agencies also received no discount and paid \$13.74 for a package of carton sealing tape when they should have paid \$3.83 (245% overcharge). State agencies received a three percent discount for a pack of 100 manila

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file jackets and paid \$249.00; but state agencies should have received a 71% discount and paid \$74.20 (235% overcharge).

Other overcharges occurred because Office Depot added items to the punch-out catalog that were available at lower prices on other statewide term contracts. For example, state agencies purchased 6,066 batteries from Office Depot for \$5,861. State agencies overpaid \$4,713 for the batteries because they were available for 411% less on statewide term contract 450A. State agencies also overpaid \$5,321 on 98 dry erase marker and cork boards purchased from Office Depot for \$10,595. The boards were already available to state agencies under statewide term contract 785A. And state agencies overpaid \$1,450 on 532 remanufactured toner cartridges purchased from Office Depot for \$39,246. The cartridges were available to state agencies under statewide contract 207A.

In addition to the overcharges, Office Depot's addition of unauthorized items to the punch-out catalog had another effect. State agencies unknowingly purchased items from Office Depot in violation of North Carolina Administration Code (01 NCAC 05B.1101) that, with a few exceptions, prohibits agencies from purchasing commodities or services covered by a statewide term contract from any source other than the vendor or vendors who are awarded the contract.

Office Depot Overcharged State Agencies \$294,413

Along with the contract violations described above, we identified numerous miscellaneous pricing errors, overcharges and undercharges.

To determine the net effect of the various contract violations and pricing errors, auditors tested state agency purchases made during the six-month period from July 1, 2007, to December 31, 2007. State agencies purchased 400,135 units of merchandise from Office Depot totaling \$2,719,506. The 400,135 units of merchandise consisted of 32,850 purchase order line items.

We selected 18,031 purchase order lines that appeared to be large dollar amounts, large quantities of items, unauthorized items, or apparent errors. We reviewed the purchase order lines individually and identified \$294,413 in net overcharges. Overcharges to state agencies included:

- \$127,664 for manufacturer labeled items;
- \$82,064 for web assortment items;
- \$72,596 for Office Depot brand items;
- \$12,089 for items available under other statewide term contracts.

Responsibility for Overcharges

P&C and Office Depot are both responsible for overcharges.

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P&C is responsible for the overcharges because P&C was responsible for the ensuring that the terms and conditions of the contract protected the interests of the State. However, P&C used contract terms and conditions that allowed the vendor to exploit the contract to the vendor's advantage. Contract terms allowed the vendor to control product identification numbers and use that control to discontinue items or make them unavailable for purchase. As a result, state agencies purchased substitute items at higher prices. The contract also contained unclear product category descriptions that allowed the vendor to control the discount an item received. Finally, the contract did not contain clear penalties for poor vendor performance, and P&C did not adequately monitor vendor performance to ensure state agencies received the negotiated discounts. We discuss these issues, and recommendations for improvement, in detail in finding number two and three below.

Office Depot is also responsible for the overcharges because the vendor was responsible for complying with the terms and conditions of the statewide office supplies term contract. However, the vendor appears to have taken action that it knew, or should have known, would violate the contract and result in overcharges to state agencies. As discussed above, Office Depot inflated retail prices for its store brand products and added unauthorized items to the punch-out catalog. These actions resulted in overcharges to state agencies. In addition, state agencies unknowingly purchased the unauthorized items from Office Depot in violation of North Carolina Administration Code (01 NCAC 05B.1101) that, with a few exceptions, prohibits agencies from purchasing commodities or services covered by a statewide term contract from any source other than the vendor or vendors who are awarded the contract.

Recommendation: P&C should pursue collection of overpayments that state agencies made on purchases from the Office Depot punch-out catalog. P&C should review Office Depot's performance and determine if Office Depot is in default of contract. If P&C finds Office Depot in default of contract, P&C should terminate the contract and consider debarring Office Depot from doing business with state agencies.

2. CONTRACT TERMS DID NOT PROTECT THE INTERESTS OF THE STATE

The Division of Purchase and Contract (P&C) used contract terms and conditions that allowed the vendor to exploit the contract to the vendor's advantage. Weak contract terms and conditions included vendor-controlled product identification numbers, unclear product category descriptions, and no clear penalties for poor vendor performance.

Vendor-Controlled Product Identification Numbers

Office Depot was able to discontinue punch-out catalog items and offer higher priced store brand substitutes because the contract terms allowed the vendor to control the product identification numbers of contract items.

P&C contracting procedures should ensure that state agencies receive the items and the prices bargained for by the State. The contract should identify items by product

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identification numbers, such as the Universal Product Code (UPC) identification numbers, that the vendor cannot manipulate. *Best Practices in Contracting for Services* from the National State Auditors Association states that contracts should “protect the interests of the agency.”

However, P&C allowed Office Depot to bid and account for contracted items according to the vendor’s stock keeping unit (SKU) numbers. SKU numbers are assigned and controlled by the retailer, and Office Depot frequently discontinued or changed its SKU numbers. We found SKU numbers that were reassigned to other merchandise, deleted, incomplete, or included additional numbers or characters so they did not match the contract.

In April 2008, we selected a random sample of 259 items from the 24,740 contracted items and searched for their SKU numbers in the State punch-out catalog. Of the items selected for testing, 105 (41%) were discontinued or not available for purchase. We projected the results of our sample to the population at a 95% confidence level. As a result, we estimate that between 8,558 and 11,501 of the 24,740 SKU numbers that the vendor used to bid the contract are discontinued or not available in the punch-out catalog.

Because contracted items were discontinued or not available for purchase, state agencies purchased substitute products at higher costs.

Unclear Product Category Descriptions

Unclear product category descriptions allowed Office Depot to sell unauthorized items and offer lower discounts than the contract required.

P&C contract terms should clearly define the products and discounts that state agencies will receive. Product categories should also be clearly defined so vendors cannot sell unauthorized items to state agencies or manipulate a contract’s discount pricing. For example, the U.S. General Services Administration’s *National Administrative Services and Office Supplies Acquisition Center* website contains clear category descriptions. *Best Practices in Contracting for Services* states that contract provisions should “define what is to be delivered.”

Nevertheless, the statewide office supplies term contract contained unclear category descriptions for office supplies, office equipment, and paper which resulted in state agencies purchasing unauthorized office equipment and overpaying for office supplies.

For some items, state agencies did not receive the negotiated 71% discount on office supplies because Office Depot misclassified the items. Office Depot overcharged state agencies \$23,930 by classifying envelopes and calendars as paper with a 50% discount. The vendor overcharged state agencies \$6,377 by classifying computer accessories, such as mouse pads and computer screen filters as office equipment with a 10% discount. And Office Depot overcharged state agencies \$10,207 by classifying chair mats as office equipment with a 10% discount.

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No Penalty for Poor Performance

P&C did not use contract terms to provide a means to penalize the vendor for poor performance.

Best Practices in Contracting for Services states:

“Specifically, the contract should contain performance standards, performance incentives and/or clear penalties and corrective actions for nonperformance, with a dispute resolution process. The contract also should include a requirement for a performance bond when appropriate.”

Penalties, such as reductions in reimbursement for noncompliance, may provide an incentive to vendors to correct errors in a timely manner. A performance bond can provide the State a means to recover overpayments or damages incurred due to vendor noncompliance.

The statewide office supplies term contract does not provide penalties against Office Depot for adding unauthorized items, inflating retail prices, or manipulating product category discounts in the punch-out catalog. Also, P&C did not require Office Depot to provide a performance bond as stated in the invitation-for-bid (IFB).

As a result, the only recourse P&C has against the vendor for poor performance is to cancel the contract and issue another bid.

Reason for Weak Contract Terms

P&C prepared a procurement document that focused on the prices and descriptions of the contracted office supplies. The contract did not include terms and conditions necessary to give P&C adequate control over product identification numbers, product categories, and vendor performance. As a result, the procurement document did not adequately address the complexities of managing an online punch-out catalog.

Recommendation: P&C should ensure that future punch-out catalog contracts identify items by product identification numbers that the vendor cannot manipulate, clearly define product categories, and provide a method to penalize vendors for poor performance.

3. PUNCH-OUT CATALOG MONITORING WAS INEFFECTIVE

Although the Division of Purchase and Contract (P&C) monitored the contract and resolved hundreds of pricing errors identified by P&C and state agencies, the monitoring procedures did not ensure vendor compliance with the statewide office supplies term contract. Procedural weaknesses included no automated contract monitoring procedures, no automated tracking of user complaints, and no training in monitoring punch-out catalog contracts.

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No Automated Contract Monitoring Procedures

P&C does not use automated monitoring procedures to identify vendor changes to the punch-out catalog in a timely manner and ensure that those changes comply with the contract.

Best Practices in Contracting for Services from the National State Auditors Association states:

“Contract monitoring is an essential part of the contracting process. Monitoring should ensure that contractors comply with contract terms, performance expectations are achieved, and any problems are identified and resolved. Without a sound monitoring process, the contracting agency does not have adequate assurance it receives what it contracts for.”

P&C manually compares the punch-out catalog prices to the contract prices, and P&C investigates and resolves pricing errors reported by state agencies. However, manual procedures are not sufficient to ensure that the vendor includes all 24,740 contracted items in the punch-out catalog at the contract price. Also, manual procedures are not efficient or effective for identifying unauthorized additions to or deletions from the punch-out catalog.

Due to the lack of automation, P&C did not determine that Office Depot inflated its retail prices, added unauthorized items to the punch-out catalog, changed product identification numbers, and overcharged State agencies approximately \$294,413.

No Automated Tracking of User Complaints

P&C does not have an efficient and effective method to track and ensure the successful resolution of state agency complaints.

Best Practices in Contracting for Services states “Monitoring should ensure that contractors comply with contract terms...and any problems are identified and resolved.” Additionally, the statewide office supplies term contract requires the vendor to resolve all overcharges within five days of notification.

P&C does not have an automated method to track state agency complaints and ensure agencies receive credits due from the vendor. Currently, state agencies report problems to P&C by telephone and email. P&C documents complaints in four sets of paper files categorized by problem type and origin of complaint. P&C does not maintain an automated database to log the date that state agencies reported the problem, log the date that P&C communicated the problem to the vendor, categorize problems by type, document each problem’s resolution, or document that state agencies received the credits due to them within the five days required by the contract.

Without an automated system for logging and tracking complaints, P&C may not process reported problems in a consistent and timely manner. Also, the contract administrator

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cannot efficiently and effectively review the status of reported problems and ensure that state agencies have received the appropriate credits.

No Training in Punch-out Catalog Monitoring

P&C has not ensured that personnel who perform contract monitoring have the knowledge and skills they need to effectively monitor an online punch-out catalog contract.

Best Practices in Contracting for Services states, “To properly monitor a contract, the agency should ensure that the contract manager possesses adequate skills and has the necessary training to properly manage the contract.” On the federal level, for example, the Office of Federal Procurement Policy established the Federal Acquisition Certification in Contracting Program to “establish core requirements for education, training, and experience for contracting professionals in civilian agencies.”

P&C has not identified and defined the tasks required to effectively monitor contracts. P&C has not formally documented the requisite knowledge, skills, and abilities that employees need to perform as a contract monitor. Furthermore, P&C has not provided formal training to help employees develop, maintain, or improve their competence in contract monitoring.

The lack of contract monitoring training increases the risk that P&C contract administrators will fail to detect vendor noncompliance. The lack of contract monitoring training also increases the risk that the State will not achieve the cost-savings for which it negotiated.

Recommendation: P&C should automate its contract monitoring and complaint tracking procedures to better ensure vendor compliance with the statewide office supplies term contract. P&C should identify position requisites and implement training for contract monitoring positions.

Auditor's Response

The Office of the State Auditor respectfully disagrees with several points made in the Division of Purchase and Contract's response.

Generally Accepted Government Auditing Standards state,

“When the audited entity's comments are inconsistent or in conflict with the report's findings, conclusions, or recommendations ... the auditors should evaluate the validity of the audited entity's comments. If the auditors disagree with the comments, they should explain in the report their reasons for disagreement.”

In accordance with Generally Accepted Government Auditing Standards, we offer clarification on the following points:

Vendor Performance Monitoring

The Division of Purchase and Contract asserts, “The vendor's performance has been continually reviewed through the monitoring of pricing and availability of products, and through direct meetings with the vendor to review contractual issues and concerns.”

We agree, and recognize in our report, that the Division monitored the Office Supplies Term Contract and identified hundreds of pricing errors.

However, if the Division had reviewed Office Depot's performance in other states it would have discovered additional information that could have raised concerns about Office Depot's ability or willingness to comply with the terms of the contract.

For example, the Division's direct experience and an Internet search should have shown:

- In May 2007, the North Carolina Office of the State Auditor issued an audit report that identified issues with the previous Office Depot contract including incorrect vendor catalog prices, overcharges, and product unavailability.
- In February 2008, the Atlanta Journal-Constitution reported that Georgia officials, “...terminated a multimillion-dollar contract with Office Depot after the company repeatedly overcharged and mispriced items for state employees.”
- In February 2008, the North Carolina Office of the State Auditor began an audit of the current Office Depot contract. Auditors started communicating identified pricing errors to Division of Purchase and Contract management in March 2008.
- In April 2008, the Nebraska State Auditor completed an audit of the state's Office Depot contract. The Lincoln Journal Star reported, “Nebraska has become the latest state to accuse office supply company Office Depot with overcharging state agencies for contracted orders and making serious pricing errors on its monthly billings.”

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- In April 2008, the San Jose Mercury News reported that an independent audit of California's Office Depot contract determined, "... the state has overpaid more than \$1 million in office supply purchases." An earlier and less extensive analysis by Mercury News of California's state supply purchases identified \$72,562 in net overcharges by Office Depot.
- In June 2008, the Palm Beach Post reported, "Florida's attorney general is investigating Office Depot, Inc. for alleged 'bait-and-switch' tactics in its office supplies contract with state and local agencies.
- In August 2008, the San Jose Mercury News reported, "Office Depot has agreed to repay the state of California \$2.5 million for overpayments, state officials said Thursday, as they released a state audit concluding that state workers routinely failed to get the best value when buying office supplies the past two years."

Consideration of this information may have given the Division of Purchase and Contract reason to increase its monitoring efforts and to be more skeptical of Office Depot's explanations concerning price discrepancies.

Contract Has Saved Taxpayers Millions of Dollars Each Year

The Division of Purchase and Contract asserts that the Office Supplies Term Contract, "has saved the taxpayers millions of dollars each year."

We assert that this statement has not been substantiated. While the contract may have saved the State money on office supplies, no one has performed an independent audit to verify the actual amount of savings that the State realized.

While we do not dispute that the contract has the potential to save the State millions of dollars each year if the vendor complies with terms of the contract, there is ample evidence that indicates the vendor has not complied with the contracted price discounts. Consequently, the State may not have experienced the full amount of anticipated savings from the Office Supplies Term Contract.

Overcharges Have Been Credited to the State

The Division of Purchase and Contract asserts, "Overcharges have been credited to the State." The Division also states, "Importantly, these reimbursements have been completed, so the net result is no harm to the taxpayers and the contract users."

Again, we assert that this statement has not been substantiated. No one has performed an independent audit to verify that state agencies have received credits for all identified overcharges. The Division of Purchase and Contract did not begin efforts to track overcharges from end-user complaints through to the credits or refunds that Office Depot issued until May 2008, even though overcharges were identified under the current and previous Office Depot contracts.

Additionally, state agencies could not have received credits for the overcharges identified by this audit because the Division of Purchase and Contract has neither asked for nor received a

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complete list of the overcharges we identified. Therefore, the overcharges identified in this audit could not have been credited to state agencies at the time of this report.

It is also questionable whether all overcharges have been identified and “...no harm to the taxpayers and the contract users” has occurred. An audit of every state agency purchase under the Office Supplies Term Contract would be necessary to identify all overcharges, and no such audit has been performed. Our audit only covered six months of transactions under the current contract, and we only reviewed a sample of those transactions. As a result, there is no guarantee that all overcharges have been identified and credited to state agencies.

Office Depot Agreed not to Recoup Repayment for Undercharges

The Division of Purchase and Contract states, “Also, the Auditor’s report fails to mention the important circumstance that Office Depot has agreed not to recoup repayment from the State for undercharges amounting to well over \$500,000.”

We agree that we did not include this issue in our report; we disagree with its relevance to our audit.

During our audit, Office Depot representatives met with the Division of Purchase and Contract to discuss the results of Office Depot’s review of state agency purchases. In a memo dated March 13, 2008, Office Depot claimed that it had identified \$594,521 in overcharges and \$802,754 in undercharges, or a net undercharge of \$208,233 “...from the implementation of the contract on March 5, 2007, through March 1, 2008.” Office Depot offered not to pursue collection of the undercharges that it had identified.

To support its assertions, Office Depot provided spreadsheets with credit data to the Division of Purchase and Contract. The Division was unable to tie the data in the spreadsheets back to individual purchase order lines for each state agency. As a result, we were unable to obtain sufficient, appropriate evidence to support Office Depot’s assertions.

Furthermore, this was not the first time that Office Depot claimed it found net undercharges in response to complaints of overcharges.

The *San Jose Mercury News* reported in April 2008 that it performed an analysis of California’s state supply purchases and identified \$72,562 in net overcharges by Office Depot. The *Mercury News* reports, “In its own analysis, Office Depot said its findings found that undercharges exceeded overcharges by more than \$45,000.” In August 2008, however, Office Depot agreed to repay the state of California \$2.5 million for overpayments.

Also, an audit of Georgia’s office supply contract in July 2007 identified overcharges by Office Depot. The audit report states that pricing irregularities, “...were then reported to DOAS (Department of Administrative Services). In turn, DOAS informed Office Depot of the problems resulting in a letter from Office Depot admitting to the core pricing irregularities. The admission by Office Depot claimed the State was undercharged in total.” After identifying additional pricing irregularities, the Georgia Department of Administrative Services decided to terminate the Office Depot contract in February 2008.

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Therefore, Office Depot's claim of net undercharges is not unique to North Carolina or unexpected. However, Office Depot's claims of net undercharges are not supported by our audit or the audits performed in Georgia and California.

Auditors Assumed the Existence of Certain Conditions that are Non-existent

The Division of Purchase and Contract asserts, "In blaming the contractor for 'inflated retail pricing,' the auditors evidently assume the existence of certain conditions that are non-existent, such as free delivery on phone or fax orders to retail stores."

We disagree with the assertion. We did not assume the existence of free delivery on phone or fax orders to retail stores to identify inflated retail pricing. We simply compared the retail prices listed on Office Depot's retail website to the retail prices listed in the State's punch-out catalog and determined that Office Depot inflated the punch-out catalog retail prices.

If retail prices in the State's punch-out catalog are higher than those on Office Depot's retail website because the State's punch-out catalog retail prices include hidden delivery charges, we recommend that delivery charges be listed separately for greater pricing transparency.

Prices Available to the General Public Are Not Relevant

The Division of Purchase and Contract states, "The analysis used by the Auditor's staff of comparing prices paid by state agencies to prices available to the general public on the vendor's website is misleading and is not relevant to the way the contract was bid."

We disagree with the above statement. The fact that state agencies could obtain the same merchandise for lower prices on the Office Depot's regular retail website than the prices that state agencies pay through the punch-out catalog with the State's discount is relevant; it is an indication of how much the retail price of Office Depot merchandise has been inflated in the punch-out catalog.

This issue has also been identified in other states.

In California, the *San Jose Mercury News* reported, "The Mercury News went onto the Office Depot retail website and found dozens of items, including data storage tapes, toner cartridges and batteries, that were either the same price or cheaper than the special rates stated in the California contract."

In Georgia, an audit of the State's Office Depot contract found that Georgia could have saved over \$8,000 on laser printers and fax machines "...using the exact same SKU (stock keeping unit) that the State purchased, but use the Office Depot retail website www.officedepot.com, the same site with prices available to anyone in the United States."

Consequently, we assert that it does not make good business-sense for North Carolina to enter a contract that requires state agencies to pay higher prices than those readily available to the general public. In addition, requiring state agencies to pay higher prices than those readily available to the general public directly contradicts the stated purpose of the Office Supplies Term Contract – to save the State money on office supply purchases.

Audit Criteria

The Division of Purchase and Contract states, “Several times the Auditor’s staff references the publication *Best Practices in Contracting for Services* from the National State Auditors Association to compare contract terms to contracting best practices. This contract is a ‘commodities’ contract, not a ‘services’ contract, which is a major difference.”

We disagree with the statement and assert that the publication cited above is applicable to the Office Supplies Term Contract. Office Depot sells office supplies to the State through a service intensive interactive web catalog. The Division of Purchase and Contract depends on the services that the vendor provides as evidenced by the Division’s response to our May 2007 audit report,

“As the Auditor is aware, web based, ‘punch-out’ catalogs are unique purchasing systems in that the Division of Purchase and Contract must rely on the vendor to post correct prices and avoid unintentional errors.”

In accordance with North Carolina e-procurement vendor requirements, Office Depot is responsible for providing the following services:

- Maintaining a website for the punch-out catalog that meets North Carolina’s technical specifications;
- Posting authorized products at the most up-to-date contract prices available;
- Ensuring that only contracted products are available for purchase by state agencies through the punch-out catalog;
- Providing customer support for site usage and order questions.

The Division’s inability to adequately monitor the services that Office Depot provided in relation to the Office Supplies Term Contract prevented the Division from ensuring Office Depot’s compliance with the contract terms.

In addition, all of the criteria we cited from *Best Practices in Contracting for Services* apply equally to commodities contracts and services contracts. We cited the following criteria in our report:

- Contracts should protect the interests of the agency;
- Contract provisions should define what is to be delivered;
- The contract should contain performance standards, performance incentives and/or clear penalties and corrective actions for nonperformance, with a dispute resolution process;
- The contract also should include a requirement for a performance bond when appropriate;
- Contract monitoring is an essential part of the contracting process. Monitoring should ensure that contractors comply with contract terms, performance expectations are achieved, and any problems are identified and resolved. Without a sound monitoring process, the contracting agency does not have adequate assurance it receives what it contracts for;

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- To properly monitor a contract, the agency should ensure that the contract manager possesses adequate skills and has the necessary training to properly manage the contract.

We assert that all of the criteria we cited from *Best Practices in Contracting for Services* are applicable to the Office Supplies Term Contract.

Items Available on Other Statewide Term Contracts

The Division of Purchase and Contract states,

“The auditor report states, ‘Other overcharges occurred because Office Depot added items to the punch-out catalog that were available at lower prices on other statewide term contracts.’ The auditor report fails to provide for certain permitted circumstances involving user discretion, and characterizes the result of such as examples of ‘overpayment.’ The cited purchases are user decisions as to which contract to buy from, and regulation of that activity is the responsibility of neither the office supplies contractor nor Purchase and Contract.”

We disagree that, “The cited purchases are user decisions as to which contract to buy from...”, and we disagree that, “...regulation of that activity is the responsibility of neither the office supplies contractor nor Purchase and Contract.”

The issue is not that state agencies had a choice of vendors. The issue is that the items should not have been available through the punch-out catalog. As described in our report, the Office Supplies Term Contract prohibits Office Depot from adding items to the punch-out catalog. The Contract also requires Office Depot to prevent punch-out catalog users from adding non-contact items to a shopping cart.

In violation of the contract terms, Office Depot added 24,284 items to the punch-out catalog without written authorization. In effect, Office Depot circumvented the State’s contract bidding process and obtained business that was rightfully awarded to other vendors. Consequently, this was not a case of providing state agencies with a choice of vendors.

The issue of adding non-contract items to the state’s catalog was also identified in other states.

In Georgia, an audit of the Office Depot contract found that Georgia contracted for 2,643 core items, but Office Depot included 30,000 items in the state’s catalog. The report also noted that contract items were not clearly distinguished from non-contract items on the website.

In California, the Department of General Services reported, “We also found that Office Depot was allowing the purchase of non-contract related items and had failed to clearly indicate to state employees responsible for placing orders which items had been significantly discounted for them.”

As for North Carolina’s contract, we assert that Office Depot is responsible for complying with the terms of the Office Supplies Term Contract, and the Division of Purchase and Contract is responsible for enforcing the terms.



North Carolina
Department of Administration

Michael F. Easley, Governor
Britt Cobb, Secretary

Division of Purchase & Contract
James D. Staton, Purchasing Officer

August 29, 2008

The Honorable Les Merritt, Jr., State Auditor
Office of the State Auditor
2 South Salisbury Street
20601 Mail Service Center
Raleigh, North Carolina 27699-0601

Re: Response to Performance Audit Report, Office Supplies Term Contract, July 2008

Dear Mr. Merritt:

The Division of Purchase and Contract appreciates the interest the State Auditor's Office has taken in the Statewide term contract for general office supplies (term contract number 615A) since it is one of the most difficult statewide term contract to administer. Even though this contract has saved the taxpayers millions of dollars each year, there is always room for improvement. The Division constantly looks for ways to improve its performance and administration of its business operations and this audit, through its findings, highlights efforts the Division is making to that end.

The State Auditor's Office confirmed and has supported the Division's own analysis and conclusions relative to the vendor's contractual performance under this contract and reinforced planned improvements in the next Invitation for Bids.

Purchase and Contract (P&C) has in all cases either already implemented the auditor's recommendations or is in the process of implementing them. Overcharges have been credited to the State. The vendor's performance has been continually reviewed through the monitoring of pricing and availability of products, and through direct meetings with the vendor to review contractual issues and concerns. The Division of Purchase and Contract was considering, prior to commencement of the audit, ending the existing contract and has now issued a draft IFB for review and comment by potential bidders leading to a new bid in the fall of 2008, and has hosted a well-attended and well-received bidder's conference in addition.

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Through ongoing monitoring, P&C was in the process of identifying overcharges by the contractor, had discovered the reasons they were occurring (mostly contractor misinterpretation of contract requirements), and was in process of requesting reimbursements. Importantly, these reimbursements have been completed, so the net result is no harm to the taxpayers and the contract users. Both parties have and will continue to enjoy the benefit of the full savings enabled by the excellent discounts offered on the contract. Also, the Auditor's report fails to mention the important circumstance that Office Depot has agreed not to recoup repayment from the State for undercharges amounting to well over \$500,000.

Also prior to the planned audit, as a result of P&C's own monitoring and analysis of the contract, P&C began to draft a new bid solicitation document to better deal with the uniqueness of a selling instrument which has only recently appeared in the marketplace -- the online "punch out" catalog. It has been documented that this new instrument is the root cause leading to the auditor's complaints. Though very convenient for ordering supplies, the downside is that these punch out catalogs are loaded with pricing which can be changed quickly and even unintentionally by involved third parties. In its next solicitation, currently in development, P&C intends to require a punch out catalog which, though still electronic, is no longer susceptible to disallowed price changes.

The Auditor's Office lack of a complete understanding of the office supplies contract and its workings has led to several statements that are misleading. In blaming the contractor for "inflated retail pricing," the auditors evidently assume the existence of certain conditions that are non-existent, such as free delivery on phone or fax orders to retail stores. There were several errors and comments that are worth noting in the interest of maintaining the accuracy of the report. The correct contract dates, per Purchase and Contract, are December 7, 2006 to December 7, 2008 rather than March 5, 2007 to March 5, 2009. The analysis used by the Auditor's staff of comparing prices paid by state agencies to prices available to the general public on the vendor's website is misleading and is not relevant to the way the contract was bid. Several times the Auditor's staff references the publication Best Practices in Contracting for Services from the National State Auditors Association to compare contract terms to contracting best practices. This contract is a "commodities" contract, not a "services" contract, which is a major difference.

We are not absolving the vendor of any wrongdoing with respect to pricing. However, the root causes discovered by Purchase and Contract are not based on whether a contractor met certain debatable conditions as posed in the Auditor's Report, but instead are based on findings and subsequent confirmation by the contractor, as follows: (a) the incorrect version of the required S.P. Richards MSRPs was initially loaded by the contractor, leading to many items with prices slightly too high, and (b) the contractor incorrectly placed some items in a 10% discount category rather than the proper 71% discount category, leading to significant overcharges, and (c) the contractor incorrectly classified thousands of office supplies items as "non-contract" and then discounted them at an improper discount, leading to major overcharges. These findings are discussed by the auditor, but the implication that Purchase and Contract was unaware of these circumstances and was taking no action until the auditors appeared is wrong.

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The auditor report states, “Other overcharges occurred because Office Depot added items to the punch-out catalog that were available at lower prices on other statewide term contracts.” The auditor report fails to provide for certain permitted circumstances involving user discretion, and characterizes the result of such as examples of “overpayment.” The cited purchases are user decisions as to which contract to buy from, and regulation of that activity is the responsibility of neither the office supplies contractor nor Purchase and Contract.

The Auditor’s Office may not approve of the methods that Purchase and Contract had to use in its dealing with this new area of electronic punch-out catalogs. But these methods did result in Purchase and Contract, free of assistance from the Auditor’s Office, in identifying the overcharges, the reasons therefore, and in obtaining reimbursements for the affected users. Again, both the taxpayer and the contract users have and will continue to enjoy the benefit of the full savings enabled by the excellent discounts offered on the contract.

Sincerely,

James D. Staton

James D. Staton
State Purchasing Officer

cc: Speros Fleggas

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