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Internal Audit Manager

December 7, 2010

Assignment 10228

To: Distribution List

Subject: Internal Audit Report – Audit of Office Depot’s Compliance with Contract Pricing Provisions

We have completed the Audit of Office Depot’s Compliance with Contract Pricing Provisions. We conducted the audit during April 2009 through June 2010 covering the period of April 1, 2007 through March 31, 2009.

We thank the Procurement Department staff for their cooperation. Their assistance contributed significantly to the successful completion of the audit.

Respectfully submitted,

Signature on file

Bill Perrone, CIA  
Internal Auditor Manager

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COUNTY OF SANTA CLARA

CONTROLLER-TREASURER DEPARTMENT – INTERNAL AUDIT DIVISION

## **INTERNAL AUDIT REPORT**

### **Audit of Office Depot’s Compliance with Contract Pricing Provisions**



Assignment 10228  
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## Executive Summary

<p><b>Conclusion</b></p>	<p>It is Internal Audit's position that the pricing terms in this contract represent an unsatisfactorily level of internal controls. This opinion is based upon Internal Audit being unable to verify the prices for non-core items which represent approximately \$3M out of approximately \$4M total annual purchases. The non-core prices could not be verified because of ambiguous formulas, inconsistent application of pricing terms, illogical pricing terms, and the vendor's failure to produce independent pricing support. For the core purchases, Internal Audit found overcharges of \$11,291 that mostly occurred when the new prices became effective.</p> <p>The Procurement Department is in agreement with the findings and recommendations contained in this report. It is not our policy to provide contractors with copies of our audit draft reports. However, since Finding 2 impacts the contractor directly, we sent the relevant supporting detail to the contractor's regional sales director. He concurred with the finding.</p>
<p><b>Audit Objective</b></p>	<p>This audit objective was to determine whether the prices charged by Office Depot are in accordance with the price agreements stated in the contract. This includes identifying both over and under billings.</p>
<p><b>Audit Scope</b></p>	<p>The scope of the audit included:</p> <ul style="list-style-type: none"> <li>• Office Depot purchases from April 1, 2007 through March 31, 2009</li> <li>• Core products sold to the County</li> <li>• Non-core products sold to the County</li> </ul> <p>We did not test for best prices.</p>
<p><b>Audit Background</b></p>	<p>This audit was requested by the Procurement Department. The County spends approximately \$4M per year on office supplies.</p> <p>The County participates in a purchasing cooperative with U.S. Communities. Per the U.S. Communities' website, "The U.S. Communities Government Purchasing Alliance ... is a nationwide purchasing cooperative designed to be a procurement resource for local and state government agencies, school districts (K-12), higher education and nonprofits. As a registered participant of the program, [agencies] can access a broad line of competitively solicited contracts which provide quality products, services and solutions." This partnership allows U.S. Communities members to increase their purchasing power resulting in greater discounts.</p> <p>Under the U.S. Communities' Office Depot contract, office supply products are classified as either core -- fixed price adjusted annually, or non-core -- variable pricing based upon discounts or cost-plus percentages. Non-core products' (except paper) prices are updated semi-annually. Paper products' pricing can be</p>

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	<p>changed more frequently with advanced notice. Approximately 75% of the County's office supply dollars were spent acquiring non-core products.</p> <p>Prior to the current contract, the County of Santa Clara contracted with Office Depot for acquiring office supplies independently of U.S. Communities. The County renegotiated the contract effective April 1, 2007 as a U.S. Communities member. Thus, the contract signed at that time is reflective of the 2006 County of Los Angeles contract because that is the basis of the U.S. Communities contract.</p> <p>We conducted our audit in accordance with the International Professional Practices Framework established by the Institute of Internal Auditors.</p> <p>Details about our findings and recommendations are provided below.</p>
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Signature on file

Bill Perrone, CIA  
Internal Auditor Manager

## Findings and Recommendations

<p><b>Finding 1</b></p>	<p><b>For the \$3M per year of non-core products purchased including approximately \$1.8M for paper, ink, and toner, the contract does not specify the particular pricing formula applicable to each order, the pricing terms were inconsistent and illogical, and there is no independent source readily available to verify the contractor's purchase price ("floor"), a key pricing factor.</b></p> <p>Core products are those sold to customers at a fixed price which may be adjusted annually. Non-core products are those sold to customers at prices based upon discounts or cost-plus percentages. This contractor updates non-core prices (except paper) semi-annually. Paper products' prices may fluctuate more frequently.</p> <p>The contractor acknowledged in a February 26, 2009 communiqué to its U.S. Communities customers that the pricing factors are complex; additionally, the contractor indicated in this communiqué that the contracts' formulas do not instill confidence in their customers' minds of the exact price they are paying. From reviewing the contract, the following are some examples of complexity and doubtfulness:</p> <ol style="list-style-type: none"> <li>1. Ambiguous formulas: The contract references its Exhibit B (Attachment A) as the basis for calculating non-core prices. Of the six categories listed in Exhibit B, five have multiple formulas. Where the multiple formulas are listed, the contract does not specify which formula is applicable in which situation. The contract does not specify if it will be the highest or lowest price of all the formulas listed within a category.</li> <li>2. Inconsistent application of pricing terms: The contract's section 10.4 states that paper will be priced according to the mill pricing. The contract's Exhibit B's paper products pricing terms are "cost plus percentage allowed from (supplier, wholesale, or Most Frequently Ordered Items) catalogs."</li> </ol> <p>Per the contract's Exhibit B, paper products were to be priced as "cost plus percentage allowed from supplier catalog: cost plus 17 GM" (17% above gross margin). For the County's largest purchased product by volume, copier paper item number 348037, the U.S. Communities' supplier catalogs effective from July 2006 through December 2008 did not publish prices. When ordering, the customer was required to contact the contractor for the current price.</p>
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	<p>3. Illogical pricing terms: For technology and paper products, Exhibit B lists various formulas such as “Cost Plus 17 GM” (GM = gross margin). In the retail industry, a product’s gross margin is the retailer’s profit as a percentage of the retailer’s sales price. Thus the formula reads as an amount (“cost”) times a percentage (117%) times a percentage (gross margin percent). If an item cost \$100.00 and the gross margin is 50%, it would be \$100.00 times 117% times 50% or a cost to the County of \$58.50 of Office Depot’s cost. If taken literally, the County is purchasing the item for \$41.50 below Office Depot’s cost. We do not believe the contractor intended to sell below cost. However, applying the terms expressed in the contract literally could lead one to conclude the contractor’s sales price was lower than its purchase price.</p> <p>4. Lack of independent pricing support: During the audit, the contractor did not produce any independent documents i.e. ones not generated by Office Depot, to support the prices it paid to its vendors. These floor prices were factored by the contractor when determining the amount it charged the County.</p> <p>In an announcement on March 29, 2010, of a revised non-core pricing structure distributed to all U.S. Communities members with Office Depot contracts, <u>Office Depot admitted the then present non-core pricing structure was “complex” and less transparent regarding ease of audit and price verification.</u></p> <p>In the written communication to its customers pertaining to this pricing matter, the contractor did not explain the reason for the various pricing factors. As a U.S. Communities participant, the County adopted the terms existing in Office Depot's contract with Office Depot's initial U.S. Communities customer, the County of Los Angeles.</p> <p>Contractual prices should be specified in the contract and/or easily computed and verified by the customer.</p> <p>Since the U.S. Communities contracts exist to assure low prices, the customers should easily be able to verify they are paying low prices. In addition to not being able to verify prices, the floating prices make it difficult to budget expenses and assess the impact on the budget.</p>
<p><b>Recommendation 1.1</b></p>	<p>The procurement process should include an analysis for non-core or floating prices that uses the prior year’s usage and proposed pricing structure in order to communicate to using departments and OBA (Office of Budget and Analysis) the impact in future years. If prior</p>

	year's usage is not available, the best estimate of usage should be used. [Priority 1]
<b>Recommendation 1.2</b>	For all pricing formulas listed in a contract, the vendor should provide clear verifiable examples prior to the County signing the contract. [Priority 1]
<b>Recommendation 1.3</b>	When possible, non-core prices should be tied to an industry index that is independent of the vendor's operation. [Priority 1]
<b>Recommendation 1.4</b>	There should be a maximum non-core price increase that would require the County to pre-approve the price increase, which would only be done after the impact has been analyzed. [Priority 1]
<b>Recommendation 1.5</b>	Annually, the Procurement Department should review the actual prior year's non-core pricing impact with the expectation for that year and update the future years. [Priority 1]
<b>Recommendation 1.6</b>	In order to better manage budgeted expenses, the Procurement Department should structure the office supplies contract and review it annually to strive to have at least 50% of the annual purchases made from core items. [Priority 1]
<b>Finding 2</b>	<p><b>After April 1, 2007, for core products, Office Depot overcharged the County \$11,291 based on the old contract prices.</b></p> <p>For purchases made between April 1, 2007 and April 16, 2007, the prices charged to the County did not agree to the contractual prices. There were some additional price variances after April 16, 2007.</p> <p>Once contracts are revised and/or new pricing schedules become effective, a contractor must load their pricing database with the updated contractual prices that will commence charging the correct price on the new contract's effective date. It appears the contractor had not updated its billing database prior to April 1, 2007.</p> <p>Outdated pricing data retained in the contractor's database caused the County to purchase goods at prices either exceeding or beneath the contractual amounts. The amount due from the contractor for core product pricing net overcharges during the audit period is \$11,291.</p>
<b>Recommendation 2.1</b>	The contractor should refund the County \$11,291 for product pricing overcharges. [Priority 2]



ATTACHMENT A

**COUNTY OF SANTA CLARA CONTRACT 5500001618  
EXHIBIT B – NON-CORE CATEGORIES AND DISCOUNTS**

All in-stock items shown in the Office Depot General Line Catalogs and United Business Products Catalogs shall be priced at the following Discounts from the Manufacturer's list price, Cost Plus Percentage or at the prices as referenced in the attached spreadsheets (Core Products).

**Note:** LL stands for Mfg. List Price Less, GP stands for Gross Profit and GM stands for Gross Margin.

1. **TONER ITEMS:**
  - A. Discount allowed from Supplier Catalog: LL 45% w/15% GP floor
  - B. Discount allowed from Wholesale Catalog: LL 10%
  
2. **FURNITURE:**
  - A. Discount allowed from Supplier Catalog: LL 45% w/15% GP floor
  - B. Discount allowed from Wholesale Catalog: LL 10%
  
3. **GENERAL OFFICE SUPPLIES:**
  - A. Discount allowed from Supplier Catalog: LL 45% w/15% GP floor
  - B. Discount allowed from Wholesale Catalog: LL 10%
  - C. Discount allowed for General Office and Stationery LL 70% w/15% GP floor
  - D. Supplies-Most Frequently Ordered Items (MFOI)
  
4. **TECHNOLOGY PRODUCTS:**
  - A. Cost Plus Percentage allowed from Supplier Catalog: Cost Plus 13 GM
  - B. Cost Plus Percentage allowed from Wholesale Catalog: Cost Plus 22 GM
  - C. Cost Plus Percentage allowed for MFOI General Office Cost Plus 13 GM and Stationery Supplies
  
5. **PAPER PRODUCTS:**
  - A. Cost Plus Percentage allowed from Supplier Catalog: Cost Plus 17 GM
  - B. Cost Plus Percentage allowed from Wholesale Catalog: Cost Plus 25 GM
  - C. Cost Plus Percentage allowed for MFOI General Office Cost Plus 17 GM and Stationery Supplies
  
6. **CATALOG PRODUCTS MARKED M AND S:**
  - A. Discounts allowed for products in Catalogs marked M and S: LL 10%