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TO: Joseph P. Lopez, Interim City Manager

FROM: Bob Deis, Senior Consultant, Public Management Group (PMG), RSHS LLP

SUBJECT: Review of Modesto's Purchasing Practices

Purpose of My Engagement

You asked that I provide an independent review of the City's past purchasing practices by City staff that apparently violated the City Municipal Code. While you and City staff have inserted many new internal controls and additional management reporting tools to reduce the likelihood of a repeat, you asked for an arms-length review that went beyond just internal processes. You wanted a City Manager perspective on the larger issues such as Modesto's organizational culture, and other factors that hopefully explain how a sophisticated organization like Modesto could allow for repeated violations of the City Municipal Code and Purchasing policy.

As you know, besides my last public-sector job as City Manager of Stockton, I have been a consultant assisting various public agencies throughout the state in troubleshooting and diagnosing public agencies, and assisting chief executives and their governing boards to improve their organizations or deal with a crisis. I have found common threads between organizations that have uncovered inappropriate practices or are dealing with substantial crises. This experience provides the appropriate context for this assignment at Modesto. I have also developed a simple model that assists in pinpointing just how purchasing and other public agency activities fit into a high-performing public agency.

It is important to mention that I did not conduct an independent audit of activities. I heavily relied on staff assistance and the accuracy of their reports. It has been my experience in conducting numerous management assessments, the employees themselves are key sources for improvements and solutions to problems. Thus, their cooperation was critical to complete your charge to me.

Executive Summary

The recently discovered errors in past purchasing practices is unfortunate, but it provides a learning opportunity for a fresh look at practices that apparently developed over multiple years.

No organization of any decent size is free of errors, it is what you do with these instances that determines success or failure in public agencies.

To satisfy my direction from you, I have highlighted 9 key observations and recommendations below, many of which your staff has already implemented on their own. I have confidence that current staff has the knowledge and ethos to implement most of them.

The two areas of recommendations that require the most heavy-lifting and constant due diligence revolve around changes in the City's organizational culture and the provision of stability. These two go hand-in-hand. Your leadership team has to be somewhat permanent and share in the same value system. They also have to reinforce that value system deep into their departments. I encourage you to think about this when considering what to do with vacant, acting or interim mid/senior level positions in the City organization. This is an area that trips up many organizations and creates the environment for unacceptable lapses like this one.

Just How Important is This Purchasing Issue to the Success of Modesto?

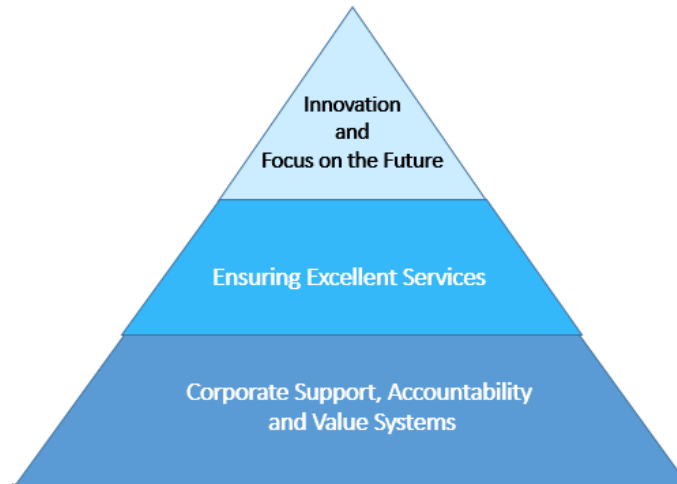
The short answer, it is very important! If there is one organized human endeavor where the “ends” do not just justify the “means”, it is the operation of our public agencies. In fact, my experience suggests the “means” are often more important than the “ends”. In other words, how public agencies provide services, make decisions, conduct business and interact with the owners of the public corporation i.e. citizens, represents the foundation of their existence.

To put this into context, I have developed this simple pyramid.

The Framework for Good Governance and High Performance

Some might initially find this next section extraneous information; however, it explains why activities such as purchasing/contracting practices are important to the success of the City and exactly where it fits in the overall performance of Modesto. This purchasing issue fits smack in the middle of the first building block—see below. Again, it gets to the foundation or legitimacy of a public agency.

The triangle below provides the building blocks for good governance in governmental agencies and the framework for how PMG evaluates public agencies and assists in creating a high-performing city. It is important to mention that each building block needs to be mastered before the organization can excel in the next block. In other words, if the City does not excel in Corporate Support, Accountability and Value Systems, it is not achieving its potential in Ensuring Excellent Services. In fact, I will give examples where impairment in the first building block caused massive harm to the delivery of services. Furthermore, if the City is not excelling in the first two blocks, it hampers its ability to take managed-risks through Innovation and Focusing on the Future.



Corporate Support, Accountability and Value Systems At the base is having strong corporate-level support systems for helping departments with what they need to deliver on their missions. It involves having the people, policies and procedures in place which support accountability, teamwork, and a high bar for values, ethics and professional standards. Due to high public agency standards around transparency, everyone eventually finds out how Modesto conducts business; thus, this building block is critical to Modesto’s success. This is what sets government apart from the private sector. How the City gets its work done is as important as what it accomplishes. If there are breakdowns in these systems, it can create barriers to departments providing good service. Problems in this area can create inefficiencies or other inappropriate activity that eat away at the legitimacy of the City in the eyes of your citizens.

Examples of processes and systems in this block include: executive direction, personnel practices and policies, the use of technology, purchasing, contracting, asset management, budgeting, accounting, treasury, internal controls and professional standards. An ethical code of conduct underlies these systems and practices along with expectations about dealing with ethical concerns as they arise

Ensuring Excellent Services This is the “bread and butter” of municipal operation; the service delivery and operations for police, fire, public works, parks and more. These departments need corporate support systems and clear direction that support them in ensuring that good services are delivered to the public. These departments should also be practicing Best Management Practices in each of their service areas. Service delivery is about having the right people in the right places along with the tools and proper direction to produce great outcomes.

Innovation and Focus on the Future The top building block is what moves a community or organization forward. It is where innovation takes place, where staff, elected and community leaders identify emerging needs and challenges and develop strategies to address or ameliorate them before they are at the steps of City Hall. This includes managed risk-taking – trying new things with the recognition that needs change and approaches need to change commensurately. This is not a “risk-free” process. However, pursuing innovation can produce the unneeded risk of mistakes if the City has not mastered the first two building blocks. There are visible examples of

mistakes in the public sector, many of which have their roots in the fact that the organization did not master the basic building blocks.

Citizens make an implicit contract with their city. They delegate or provide immense power and resources to their public agency via their governing body, but in return they expect their business practices are beyond reproach and they will get excellent services and a good quality of life in return. The authority for staff to conduct business is delegated through their elected officials and if there is a breakdown in that area, we have a fraying of that contract. Violating and ignoring the City code gets to the heart (the first building block) or foundation of this framework for governance.

In other words, this purchasing issue is a big deal!

Now, let's take this theory and apply it to real examples that I have been personally involved in from the past. The primary cause for Stockton's bankruptcy was failure at the first building block. For San Bernardino, it was the first and second building blocks. A former client, the City of Beaumont's unprecedented crisis was due to a complete failure at the first building block, with their contracting/purchasing processes playing a large part in that city's problems. As background, Beaumont was highly insolvent, had almost \$90 million in court judgments or claims against it and 7 former executives were indicted, 6 of which pled guilty. Oxnard's crisis was due to failure at the first building block as well. Ultimately, on the journey to repair these organizations, they had to make massive cuts in services to balance their budgets.

How Does Modesto Compare to Other Agencies?

Modesto is nowhere near the state of the cities that I mentioned above. Yet, those cities began their long journeys towards a major crisis, years earlier, with singular issues like Modesto's past purchasing practices. However, unlike Modesto, they were left unaddressed by the other cities. Eventually, it is the accumulation of inappropriate practices that caused the catastrophic problems in those cities listed above. I call this dynamic "death by a thousand cuts". This is where the organizational culture in addition to internal controls plays a part in questioning poor practices and ensuring this doesn't happen again, or else activities simply get worse.

Every distressed client that I worked with cut budgets in their support functions (e.g. purchasing) and did not restore these staff after the Great Recession. Yet, they did not revisit the same rules they were responsible for enforcing, and consider possible changes commensurate with the lower staffing. As a result, a "Catch 22" situation is created and staff struggled to keep up with the demand. Every client that I worked with had problems in contract management. However, none of them experienced the apparent collaboration of multiple purchasing staff to regularly ignore and violate their City Municipal Code for purchasing rules over a period of time.

Every client had high-turnover in their leadership ranks with the long-term "interim" status linked to their titles. They had other key technical positions that were not refilled for extended periods of times. Turnover and long-term vacancies or interim status for executives and other

staff creates the environment for mistakes and stagnation when addressing a city's challenges. And every client had an organizational culture that needed repair. Let me speak to this last issue.

Organizational cultures are the rules, norms, practices and the ethos that guides and represents the business practices of a public agency. They can be healthy cultures, which are typically designed and managed around key principles or they can be unhealthy ones. If they are not managed, cultures are organic and formed by themselves based on what individual employees see that works or doesn't work for them. In these unmanaged cultures, one individual can capture too much unchecked discretion or power. The cultures of the cities in crisis mentioned above were unhealthy, with very little internal questioning of practices and organizational direction—a form of “group think”. Without that internal questioning of the status quo, the norm keeps moving the organization gradually and consistently to the big crisis, which brings me to Modesto.

While I did not conduct a thorough review of Modesto's culture, I did interact with the senior leadership of the City to assist in performing my charge from you. I was surprised to hear that many operating departments, at least up to now, did not perceive any prior role in ensuring conformance with the City Municipal Code when it came to contracting/purchasing practices. Again, a basic internal control and a key component of a healthy culture is the shared responsibility of good business practices. I'm sure these same departments will express opinions when it comes to personnel matters, but why not contracting/purchasing matters? They deferred to the purchasing to perform their magic, which is a concern.

With respect to contract management, the desired approach is to have multiple gatekeepers to ensure conformance with Council policy and the City Municipal Code. The department that uses the goods or service should be the first gatekeeper. It has a vested interest in picking the best vendor, authorizes and controls the services, and receives and reviews the invoices. It should be the first line of defense in monitoring contracting practices. The second gatekeeper is the central support function i.e. purchasing, which creates and monitors procedures that comport with the City Municipal Code and ensures compliance with the same. It also assists departments in getting the most cost-effective goods and services. The third gatekeeper is typically a robust accounts payable function, this is the last downstream control where nothing gets paid without proper expenditure authority and approvals. The fourth gatekeeper role is the design of the internal control systems to ensure separation of duties and that all transactions have the appropriate review to ensure conformance with City Council policy and the City Municipal Code.

It is the interplay of all four gatekeepers, fulfilling their respective roles that ensures the business of the City continues but with the proper conformance with the City code.

What Happened in Modesto and What Should You Do About it?

As I mentioned, you and your staff have already identified many of these shortcomings and instituted various measures to ameliorate risk, but some of my observations and recommendations are new.

Observation #1—City Code Compliance Is a Shared Responsibility

As suggested above, the operating departments did not see their role in performing the **first gatekeeper role**. This error was implicitly facilitated by past City management not articulating that role and providing the tools to fulfill that role. Remember, absent a managed culture individuals fill the vacuum with their own perspectives. The responsibility for conformance with the City Municipal Code is a shared responsibility and is not compartmentalized. This is your protection against the crises experienced in those other cities mentioned above. Additionally, departments were regularly exceeding their estimated expenditure activity early on in multi-year agreements; thus, adding to the pressure of returning to Council for further amendments.

Recommendation #1—Enhanced the Operating Departments Role

As I suggested earlier, fulfilling the first block of good governance as depicted above i.e. compliance with the City Municipal Code, is a shared responsibility. Operating departments are in the best position for planning and managing the use of goods and services. They receive the invoices, so they can monitor usage vis-à-vis contract dollar caps. However, they need the requisite training and information tools to fulfill this role. You have already clarified your new expectations and your staff has committed management reporting tools to assist in this effort. However, this new role should be memorialized in writing along with the management tools to perform it e.g. tickler file to warn when termination dates are arriving and expenditure activity reports to assist in complying with caps. This could be done via insertion in the Purchasing Manual and/or an administrative directive. Also, departments should invest more effort in estimating and tracking their expenditure needs.

There is an enhanced complication when more than one department is using the same agreement or purchase order. This requires coordination and one “owner” which your staff has already provided for, going forward. You have also “forced” an allocation of the approved expenditure authority to each participating department for control points. This should help address this complication.

I recommend that each department identify at least one staff member that is assigned the task for contract and purchasing compliance. They should be the recipients of a new training effort by Purchasing and be part of an interdepartmental team going forward. They will be the experts, to share information and provide Purchasing feedback on improvements needed, and other matters. Whenever there is turnover in these positions, purchasing will ask the department head for the new designee, immediately.

Observation #2—Purchasing Staff Collaborated on Violating the City Municipal Code

The **second gatekeeper role** obviously failed where Modesto apparently experienced a unique collaboration across multiple purchasing staff to circumvent conformance with policies and the code. I have never seen purchasing staff willing to amend contracts (both term and dollar amount), or create a new contract without the proper Council approval. It worked because they could change the contract amounts in the Oracle system, which accounts payable relied on to approve payment. The fact that operating departments did not question this practice, when it involved contracts solely for their department’s use, is surprising to me.

Purchasing staff regularly over road the very controls they were to enforce in the City. It also appears new staff were not provided the requisite training in the Oracle system and the Municipal Code.

Recommendation #2—Enhanced Oracle Controls and Review Responsibility

To prevent inappropriate changes in the Oracle contract amounts that are not in conformance with City Municipal code, you have added an extra level of review, the Director of Finance. And to ensure the Oracle caps are consistent with the Council approval amounts you have added the step to electronically file the actual agenda item, City Resolution and signed agreement to the Oracle system as a reference for the approver to review. You should now have the buyer be responsible for original entry of purchasing limits. The purchasing manager will be the second reviewer and the Director of Finance be the third. I believe this a good response to the situation, but you might consider also adding a scheduled internal audit to test the accuracy of the inputs after staff has had time to implement all these recommendations.

An additional issue that was uncovered in the City's review of past practices is the interpretation and control of rate increases in multi-year agreements. Your staff plans to load approved rates and related information in the Oracle system to aid in the review of these items. The Oracle system will be an enhanced repository of critical information what will help in the control of spending practices.

Observation #3—Blanket Purchase Orders (BPO's)

Other violations of the City Municipal code involved the use of BPO's, an expenditure authorization that lasts only a fiscal year. Staff can purchase up to \$50,000 in goods and services without separate Council review, subject to certain conditions. An extensive list of BPO's (over 300) were regularly approved each year, with little apparent oversight and review, and roughly 13 were regularly exceeded, or others (84) were hardly used and 100 not at all, based on reviewing the activity for Fiscal Year 2017-18. This later practice is not a violation of policy but it wastes staff resources and suggests a general lack of purchasing management review over this BPO process.

Recommendation #3—Conduct Thorough Review of BPO Process

Clearly, a wholesale review of this BPO needs to be completed before the next fiscal year. Given a third of them were not used at all when we reviewed them in November and almost another third was hardly used at all, this program is ripe for paring down. Given the long list of BPO's, some likely cover the same type of goods or services, which suggests combining them into Annual Agreements should be an explored alternative. The regular violators of the \$50,000 cap should be converted to Annual Agreements; a reporting system needs to be created to track trends and assist in predicting those reaching the cap; and, there needs to be a hard stop with no amendments allowed in the system that facilitates the violation of the City Municipal Code.

Observation #4—The \$50,000 Threshold for City Council Review

Another source of confusion and arguably a source for City code violations is the criteria for determining when the \$50,000 cap applies, as mentioned earlier. For BPO's it is clear to everyone the \$50,000 cap applies and resets annually. Yet, when Annual Agreements (essentially

multi-year PO's) and multi-year professional services agreements are in place, some operating departments thought the \$50,000 cap (for determining when Council must review it) reset every year. The City Attorney's Office has opined the compliance with the \$50,000 cap is determined by the cumulative expenditure activity over the life of the contract/agreement. It is purchasing's role to clarify this, communicate and train staff on it, along with creating systems to ensure it is enforced in the organization. They apparently did not do this.

Recommendation #4—Memorialize the Interpretation of the \$50,000 Cap

The City Attorney's interpretation of this standard, along with any other interpretations, should be memorialized in writing and inserted in the Purchasing Procedures Manual and/or administrative directive, included as part of any training program and shared with the cadre of departmental experts as Recommended in #1 above. The department heads should be responsible for disseminating this information to the appropriate staff.

Observation #5—Purchasing Staff Levels

The City commissioned an independent review of purchasing processes and staffing levels by Management Partners. Their review was not a detailed audit of transactions but a staffing and process review from 10,000 feet. They compared Modesto's staffing levels to similar cities and found that your staffing was the second lowest. This lower staffing creates a longer queue for bids that in turn creates the potential for exceeding contract limits before they are properly amended or renewed.

Recommendation #5—Consider Adding Staff or Changing the Purchasing Standards

As mentioned earlier, Modesto is not unlike other clients where, in order to get through the Great Recession, they reduced staff but kept the same rules for purchasing including an increase in volume with purchasing bids/proposals. While this never justifies violations of the City Municipal Code or policy, this has consequences where there is a backlog of purchasing activities that enhancing the likelihood of exceeding contract or PO caps. Of course, the alternative is to shut down or reduce services without these resources. This is not an acceptable alternative as well.

Management Partners compared Modesto purchasing staffing levels with similar cities and opined you should add one more staff person, along with other upgrades. This was recommended before identifying the various shortcomings in the City purchasing/contracting processes. Furthermore, there is a pent-up backlog of activity that needs addressing to correct and catch up on purchasing processes. The Purchasing Division is currently dealing with a huge backlog of over 100 RFPs and RFBs which need to be addressed immediately. After catching up and reaching a steady-state, then there will be an optimum permanent staffing level. You have authorized 3 temporary part-time staff, but eventually the City needs to have an honest conversation whether the current purchasing standards are appropriate, then you have to allocate adequate permanent staff to perform their role. I also recommend that you consider the combination of skill sets in purchasing and develop a new permanent staffing arrangement that combines advanced skills (sr. buyer) and entry level skills (buyer).

Additionally, in the interviews conducted of staff it was clear that a formal training program was missing for new purchasing staff. There should be a new employee orientation program

developed for every new purchasing staff member, with a focus on the City Municipal Code, role of purchasing, role of the department, this lesson learned, etc.

Observation #6—Sole Source/Brand Purchases

Even when public agencies obsess over ensuring there is adequate and fair competition for City business, there will be times when only one vendor can provide the goods or services to the City. This is called a sole-source purchase. A variation of this is the sole brand purchase. The typical areas for sole source are: software maintenance for an application that does not have multiple vendors to support it; repair of specialized equipment where there is not a robust distribution or repair system; or, the department has adopted standards and already justified to purchasing it is in the best interest of the City to only use, say a Ford SUV for police patrol. The brand may be a standard after substantiating economies of scale, cost of parts, specialized expertise, etc. This last example is called a sole brand purchase, where the Ford SUV is standard but there are multiple vendors that can provide it.

When determining whether sole source is justified, it can be subjective, requiring some professional judgment and discretion. In working with staff and reviewing past sole source usage (FY 14-15), we have identified 119 examples of sole source purchases which seems too high. We took a 25 percent sample of these and have identified some (roughly 20 percent) that did not appear to meet the strict interpretation of sole source or lacked the supporting information i.e. justifying that only one vendor can provide the goods or services needed by the City. In these cases, they should have used a request-for-approval (RFP) process where quality and price were used to evaluate the trade-off between the two.

The City Municipal Code implicitly allows for a sole source and other exceptions to the bidding requirements for purchases greater than \$50,000. However, it delegates authority to the Purchasing Manager to make that decision. This is a control weakness i.e. relying on one person to make that call. Another level of review for these exceptions should take place. Sometimes due to emergencies (exigent circumstances) a sole source purchase has to occur; thus, the Code allows for a purchase to respond to an emergency. Again, these should be reviewed by the Director of Finance.

Recommendation #6—Enhance the Review and Training for Sole Source/Brand Purchases

Whenever a sole source purchase is initiated, there should be a written department head request (not to be delegated) and if the Purchasing Manager determines standards are met, then the Director of Finance should review and approve these transactions.

The Purchasing Procedures Manual that covers the sole source criteria and process should be reviewed and improved. The Manual identifies a list of questions to be answered when submitting a request, but there should be more elaboration on exactly when a sole source is appropriate and when it is not appropriate, with real examples. This would be included in a new training program.

Observation #7—Sharing Contracting Authority Between Multiple Vendors

As you know, there were times when staff went to Council for approval of multi-year “Annual Agreements” with a maximum amount but shared between vendors. There apparently was

confusion on how to allocate the cap between vendors and controlling for compliance with the total expenditure authority.

Recommendation #7—Provide More Source Documents in the Oracle System

As you also know, your staff has added source documents into the Oracle system e.g. agenda items, to increase the likelihood that the Oracle amounts are consistent with Council direction. Your staff is also forcing the sum total of the contracts to equal the Council action. Finally, I believe this process along with others should be memorialized in a document and included in any training efforts of new purchasing staff.

Observation #8—Accounts Payable

The **third gatekeeper** role worked, except for the “override” role played by purchasing staff and other system weaknesses mentioned elsewhere in this report. What controlled the damage was the fact that accounts payable plays a “hard stop” role and did not allow for payments that were not in the Oracle system—notwithstanding other errors and system weaknesses.

Recommendation #8—Accounts Payable

Please note other system recommendations throughout this report. If these other enhancements are implemented, the utility of accounts payable as an additional control enhances as well.

Observation #9—Internal Controls

Using hindsight to my benefit, the **fourth gatekeeper** role of internal controls could have been more robust. A system of internal controls is like a bicycle chain, it is only as strong as its weakest link. For example, if the first gatekeeper role is not there, it provides too much discretion and autonomy somewhere else. This provided the conditions for purchasing to inappropriately amend contract amounts, i.e. the chain breaks.

Your staff has also identified other internal control weaknesses. Professional services contracts had not been entered into the Oracle system to assist in ensuring their compliance with the City code. When a request is made to accounts payable, staff uses what is called a Non-PO payment request. This process bypasses many of the controls and tools in place to ensure contract/purchasing activity comports with the City Municipal code. As a result, staff has begun to enter these into the Oracle system. Thus, the additional control added by the accounts payable function can be added to professional services.

Recommendation #9—Review of All Non-PO and Other Expenditures

As your staff has already started, all professional services agreements should be entered into the Oracle system. All Non-PO or other expenditures not going through your payroll or Oracle system controls, should be thoroughly reviewed as candidates to be entered into one of these systems. These will be your two “tried and true” systems that will have adequate controls in place. Any expenditure activity that does not rely on these system’s controls e.g. Non-PO’s, should be evaluated and considered for change.

Given your experience with contracting and purchasing issues, you might consider reviewing your credit card usage and compliance with Council policy and administrative rules. This is an

area that many clients are having issues with, even though it is an efficient way for operating departments to make smaller purchases.

Concluding Remarks

Breakdowns in the City's processes is unacceptable and must be addressed to regain the public's trust. I mentioned above how integral this issue is to good governance. Having said that, I wish to provide some additional context. There were over 1,000 purchase documents in the City's systems. City staff reviewed all of them and identified 45 that violated City Municipal code or policy. I recognize one violation is too much, but the balance of the activity appears to comport with the City Municipal code and policy.

Yet, I do not recommend you stop with the improvements mentioned above. It does not take much leap in logic to question if there was any malfeasance considering the apparent proclivity of bypassing the City code. To that end, I encourage the appropriate due diligence to ensure no City employee participated in any malfeasance or fraudulent activity. As you know, we are pursuing this effort and have yet to find evidence of this. However, this later effort has to be methodical and thorough but also take into account the cost/benefit of additional effort. This will continue as of the publishing of this document and will continue afterward.

I believe the City has made a substantial effort to both understand and fix the purchasing processes. This a key difference from the other organizations that I mentioned above. Every crisis is a learning opportunity and you are making great efforts to ensure this does not repeat itself in the future.