
Procurement Examination of the Department of Health: Lack of Procurement Controls Exposes Health Department to Waste and Abuse

A Report to the
Governor
and the
Legislature of
the State of
Hawai'i

Report No. 15-09
July 2015



THE AUDITOR
STATE OF HAWAI'I

Office of the Auditor

The missions of the Office of the Auditor are assigned by the Hawai'i State Constitution (Article VII, Section 10). The primary mission is to conduct post audits of the transactions, accounts, programs, and performance of public agencies. A supplemental mission is to conduct such other investigations and prepare such additional reports as may be directed by the Legislature.

Under its assigned missions, the office conducts the following types of examinations:

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2. Management audits, which are also referred to as performance audits, examine the effectiveness of programs or the efficiency of agencies or both. These audits are also called program audits, when they focus on whether programs are attaining the objectives and results expected of them, and operations audits, when they examine how well agencies are organized and managed and how efficiently they acquire and utilize resources.
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4. Sunrise analyses are similar to sunset evaluations, but they apply to proposed rather than existing regulatory programs. Before a new professional and occupational licensing program can be enacted, the statutes require that the measure be analyzed by the Office of the Auditor as to its probable effects.
5. Health insurance analyses examine bills that propose to mandate certain health insurance benefits. Such bills cannot be enacted unless they are referred to the Office of the Auditor for an assessment of the social and financial impact of the proposed measure.
6. Analyses of proposed special funds and existing trust and revolving funds determine if proposals to establish these funds are existing funds meet legislative criteria.
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Department agreed to nearly double the contract price, drastically extend the deadline for deliverables, and cut the deliverables by two-thirds.

Recommendations

Response

Prior Audits

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Report No. 15-09, July 2015

Health department's decentralized procurement system lacks clarity, consistency, and oversight

Department provides little support for and minimal oversight of staff involved in procurements

With the diversity of its programs, the department's delegation of procurement functions to individual staff is understandable. However, we found there is minimal oversight over these staff and no process to provide them with procurement service support. When a procurement issue arises, staff do not have clearly defined procedures for how they should obtain technical assistance. Some staff consult with the Administrative Service Office, while others go directly to the Department of the Attorney General or the State Procurement Office for advice. In addition, the department does not systemically review procurement activities to monitor and promote compliance to ensure that all staff adhere to key procurement requirements, particularly contact administration. This scarcity of oversight and support exposes the department to risks that purchases will not meet procurement requirements and jeopardizes the department's assurance that it is receiving what it has paid for.

We found that only one of the five divisions we reviewed has a procedures manual for evaluating and monitoring contracts. Consequently, monitoring practices among divisions were generally informal and vastly inconsistent. We also found there is no oversight of contract administrators or a periodic and systematic review to ensure that functions are being conducted appropriately. Of 55 contracts we reviewed, nine did not have completed monitoring reports. In two cases, staff incorrectly believed that monitoring was not required; for the remaining seven contracts, staff blamed the lack of contract monitoring on a shortage of staff resources. We also found that the department did not have documentation of when proposals were received for eight of 40 contracts we tested (20 percent).

Contract for redemption centers audit exemplifies DOH's faulty procurement process

In October 2008, the department sought a contractor to audit six certified redemption centers in the Deposit Beverage Container (DBC) Program. The contract was solicited and awarded via a request for proposals (RFP), which is designed to solicit multiple bidders. However, only one bid was received, and the contract was renegotiated with the sole bidder from \$76,400 to \$340,000 (an increase of 345 percent). Over the next three years, the contract was amended three times, increasing the total award to \$543,374 (611 percent above the original bid), extending the contract by one year, and reducing the number of redemption centers to be audited from six to two. The department eventually accepted the first redemption center audit report but rejected the contractor's draft of the second. However, since the contract's procurement was fundamentally and significantly flawed, we question the value of either audit effort.

Agency response

In its response to the audit, the department did not dispute our findings or recommendations. In order to better clarify roles, responsibilities, and procurement procedures, it will be forming an internal procurement working group to further assess its current decentralized system. While it acknowledged that its contract with Grant Thornton LLP/PKF Pacific Hawai'i LLP had problems, it did not believe that its procurement and monitoring of this contract accurately reflects the department's procurement practices as a whole. However, it will utilize the findings of the audit to improve future contracts and avoid repeating past mistakes.

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A Report to the
Governor
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the State of
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Conducted by

The Auditor
State of Hawai'i
and
KMH LLP

Submitted by

THE AUDITOR
STATE OF HAWAI'I

Report No. 15-09
July 2015

Foreword

This is a report on the procurement examination of the State of Hawai'i, Department of Health, for the fiscal years ended June 30, 2012 and June 30, 2013. The examination was conducted pursuant to Section 23-4, Hawai'i Revised Statutes, which requires the State Auditor to conduct postaudits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivisions. The examination was conducted by the Office of the Auditor and the certified public accounting firm of KMH LLP.

We wish to express our appreciation for the cooperation and assistance extended by the director and staff of the Department of Health during the course of the examination.

Jan K. Yamane
Acting State Auditor

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Chapter 1

Introduction

This procurement examination of the Department of Health for fiscal years ended June 30, 2012, and June 30, 2013, was conducted by the Office of the Auditor and the independent certified public accounting firm of KMH LLP pursuant to Section 23-4, Hawai‘i Revised Statutes (HRS), which requires the Auditor to conduct post audits of the transactions, accounts, programs, and performance of all departments, offices, and agencies of the State and its political subdivisions.

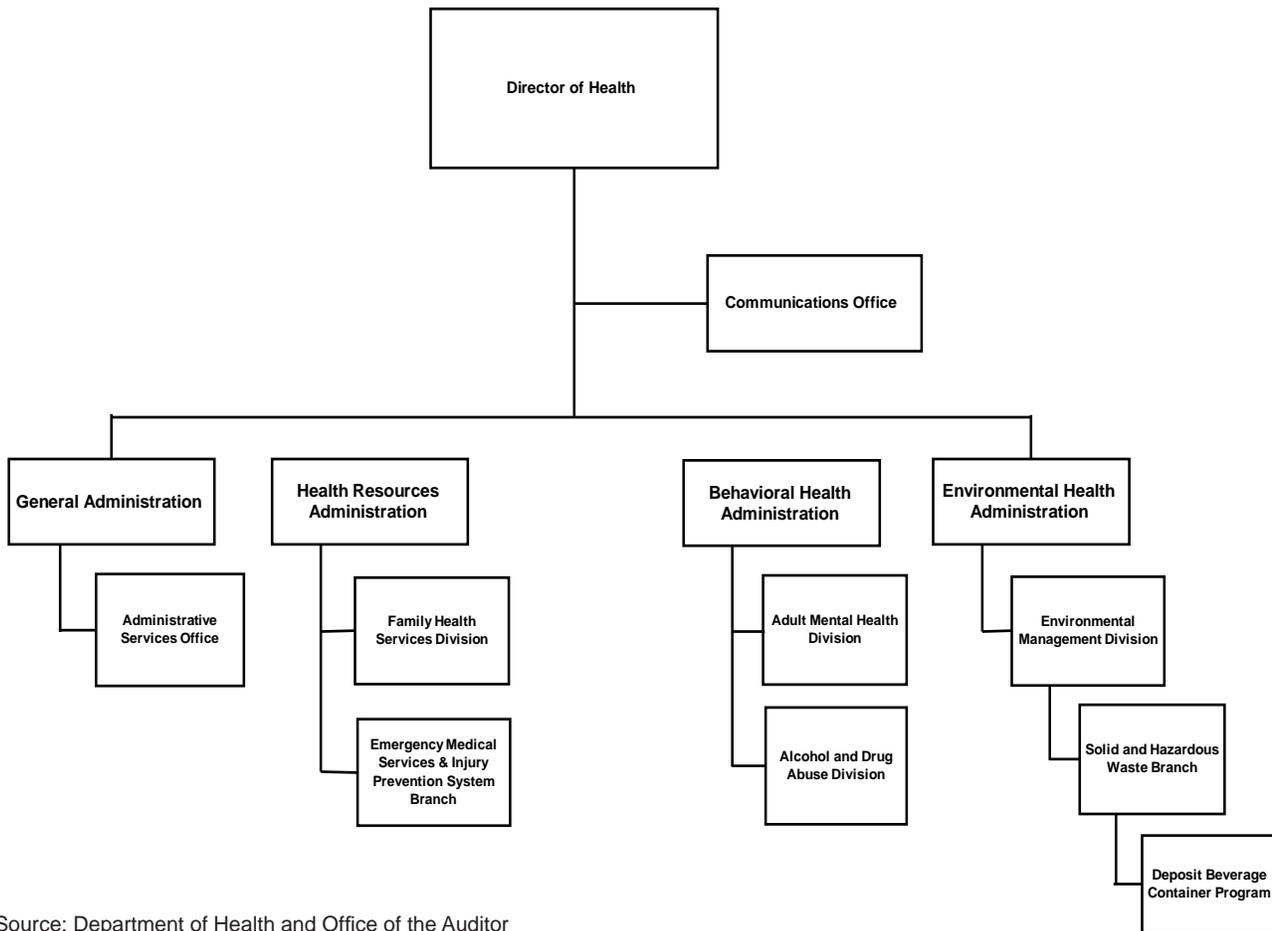
Background

The Department of Health’s (DOH) mission is to protect and improve the health and environment for all people in Hawai‘i. It administers and oversees statewide personal health services, health promotion and disease prevention, mental health programs, monitoring of the environment, and enforcement of environmental health laws. To achieve these objectives, the department coordinates with other state, county, federal, and private agencies.

Department of Health organization

The department consists of a Communications Office and four administrative areas (Administration, Behavioral Health, Environmental Health, and Health Resources). These areas administer ten divisions and 13 offices and branches. Our examination focused on the department’s Family Health Services Division, Emergency Medical Services and Injury Prevention System Branch, Adult Mental Health Division, Alcohol and Drug Abuse Division, and Environmental Management Division. Exhibit 1.1 shows the department’s office, divisions, branch, and program relevant to our examination.

Exhibit 1.1
Department of Health Organizational Chart Showing Relevant Office, Divisions, Branch, and Program



Source: Department of Health and Office of the Auditor

Administrative Services Office

Located under General Administration, the Administrative Services Office is responsible for overseeing the department’s procurements and advising the department on compliance with the *Hawai’i Public Procurement Code*, Chapter 103D, HRS, and *Purchases of Health and Human Services*, Chapter 103F, HRS.

Family Health Services Division

Within the Health Resources Administration, the Family Health Services Division aims to ensure that all families, women, men, pregnant women, parents, infants, children, children with special health needs, and adolescents receive quality prevention and intervention services based on their needs.

Emergency Medical Services and Injury Prevention System Branch

Also under the Health Resources Administration, the Emergency Medical Services System Branch aims to minimize death, injury, and disability due to life-threatening situations by ensuring the availability of high quality emergency medical care through the development of a system capable of providing coordinated emergency medical and health services.

Adult Mental Health Division

Within the Behavioral Health Administration, the Adult Mental Health Division seeks to improve the mental health of Hawai'i's people by reducing the prevalence of emotional disorders and mental illnesses. Services include mental health education, treatment and rehabilitation through community-based mental health centers, and an in-patient state hospital facility for the mentally ill, including those referred through courts and the criminal justice system.

Alcohol and Drug Abuse Division

Also located within the Behavioral Health Administration, the Alcohol and Drug Abuse Division aims to reduce the severity and disability effects related to alcohol and other drug use by assuring access to an integrated, high-quality, public/private community-based system of prevention strategies and treatment services designed to empower individuals and communities to make health-enhancing choices regarding the use of alcohol and other drugs.

Environmental Management Division

Under the Environmental Health Administration, the Environmental Management Division is responsible for implementing and maintaining statewide programs for controlling air and water pollution, ensuring safe drinking water, properly managing solid hazardous waste and regulating the state's waste water. The division oversees five branches, including the Solid and Hazardous Waste Branch, which in turn is responsible for the Deposit Beverage Container (DBC) Program. The DBC Program uses redemption centers to collect empty beverage containers and return deposits to consumers, as well as to deliver redeemed beverage containers to recyclers.

Department of Health financial information

The department is responsible for more than \$658 million in annual expenditures. Exhibit 1.2 presents the department's summarized financial results for the fiscal year ended June 30, 2013.

Exhibit 1.2
Department of Health Summarized Financial Results, Fiscal
Year Ended June 30, 2013 (rounded to nearest thousand)

Revenues	
Program revenues	\$ 173,813,000
General revenues	<u>527,837,000</u>
Total revenues	701,650,000
Expenses	
General administration	36,945,000
Environmental health administration	49,409,000
Behavioral health administration	228,744,000
Health resources administration	331,127,000
Other	<u>12,750,000</u>
Total expenses	658,975,000
Transfers out, net	<u>(14,639,000)</u>
Change in net position	<u>\$ 28,036,000</u>

Source: Compiled by KMH LLP based on audited financial statements of Department of Health

***Delegation of
procurement authority***

The State Procurement Office (SPO), which is administratively attached to the Department of Accounting and General Services, advises governmental bodies on the state's procurement process and distributes procurement circulars, guidance, and directives to all state entities. The SPO administrator is the chief procurement officer (CPO) for the executive branch, including the Department of Health. The State's CPO may delegate any authority conferred by the procurement code (Chapter 103D, HRS) to designees or to any department, agency, or official within his or her respective jurisdiction. In the case of DOH, the SPO administrator has delegated CPO authority to the director of health.

CPOs are responsible for procuring or supervising the procuring of goods, services, and constructions or health and human services; exercising general supervision and control over all inventories; and establishing and maintaining programs for the inspection, testing, and acceptance of goods, services, and constructions. Operational procedures consistent with Chapters 103D and 103F, HRS, and Hawai'i Administrative Rules (HAR) may be adopted to assist in performing these duties.

For the fiscal years we examined, the director of health had delegated her CPO authority to designated departmental personnel via various SPO procurement delegation forms. The forms indicate the individuals

to whom the director delegated procurement authority and the specific levels of authority delegated. The delegation forms are maintained and monitored by the department's Administrative Services Office.

DOH's procurement process

The contract procurement process has two main parts: solicitation and administration. *Contract solicitation* involves identifying the need for goods or services through awarding a contract. *Contract administration* starts from contract award and ends when all deliverables have been received and final payments are made to close out a contract.

DOH's procurement process starts within each division, branch, or office. Program personnel identify goods and services needed and determine an appropriate procurement method. Depending on the type of procurement, divisions, branches, and offices procure goods directly or work through the department's public health administrative officer or designee.

DOH's intranet contains guidance and templates on the different types of procurement methods available to the divisions, branches, and offices. DOH also has access to SPO circulars and training materials for direction on procurement.

Procurement methods

The department's procurements are governed by the *Hawai'i Public Procurement Code* (Chapter 103D, HRS), *Purchases of Health and Human Services* (Chapter 103F, HRS), and the State Procurement Office. Chapters 103D and 103F, HRS, were enacted in 1993 and 1997, respectively, to promote economy, efficiency, and effectiveness in procuring goods, services, and construction of public works for the State and counties. Chapter 103D applies to all procurement contracts made by state government bodies unless specifically exempted. Chapter 103F applies to purchases of health and human services, and purchases under this chapter are specifically exempt from Chapter 103D requirements except where otherwise stated. The state's procurement process is meant to foster broad-based competition, provide best value to the State, and ensure fiscal integrity, responsibility, and efficiency.

There are 13 methods of procurement available under Chapters 103D and 103F, HRS. Procurement methods available under Chapter 103D include competitive sealed bids, competitive sealed proposals, professional service contracts, sole source procurements, small purchases, emergency procurements, and exempt procurements. Procurement methods available under Chapter 103F include competitive purchase of services, restrictive purchase of services, treatment purchase of services, small purchases, crisis purchases of services, and exempt purchases of services.

Competitive purchase of services, also known as request for proposals (RFPs), is the standard method of procuring health and human services unless otherwise allowed by law or approved by the CPO. Prior to developing an RFP, a procuring entity (in this case, an office, division or branch) must prepare a request for information (RFI) to obtain community input and facilitate community planning activities. The procuring entity then uses the information from an RFI to prepare the scope for an RFP. Under a competitive purchase of services, a department may award multiple contracts if it is deemed to be in the best interest of the State. Otherwise, this method is similar to competitive sealed proposals under Chapter 103D, HRS.

Prior Audits

This is our first department-wide procurement examination of the Department of Health. However, we have conducted several audits that addressed procurement in the department and its divisions.

Our 2002 *Audit of Adult Mental Health Division's Management of Contracted Community Services* (Report No. 02-06) found that the department did not award a contract in accordance with the principles of open competition—specifically, significant modifications to the contract and a failure to follow contracting guidelines. We also found the division lacked proper management of contracted community-based mental health services.

Our 2004 *Financial Audit of the Department of Health* (Report No. 04-05) found that DOH failed to comply with procurement codes regarding small purchases and contractual services. We also noted the department lacked formal policies and procedures over its contract management process. We found instances where contractors began providing services prior to execution of a formal contract and one instance where the department made an improper payment to a vendor.

We have also performed four management and financial audits of the department's Deposit Beverage Container Program. Our 2015 *Financial and Program Audit of the Deposit Beverage Container Program, June 30, 2014* (Report No. 15-02), our 2013 *Management and Financial Audit of the Deposit Beverage Container Program, June 30, 2012* (Report No. 13-08), and our 2012 reports, *State of Hawai'i Deposit Beverage Container Deposit Special Fund Financial and Program Audit, June 30, 2010* (unnumbered) and *State of Hawai'i Deposit Beverage Container Deposit Special Fund Financial and Program Audit, June 30, 2008* (unnumbered) all found that the program relies on self-reported data from distributors who may be fraudulently or erroneously under-reporting beverage containers sold or distributed and certified redemption centers that may be fraudulently or erroneously

over-reporting beverage containers redeemed. This flaw, coupled with an absence of a detailed audit function, exposes the program to abuse and risk of fraud, which threaten the financial sustainability of the program.

Objectives of the Examination

1. Examine the effectiveness of the Department of Health's internal controls over its procurement of goods and services.
2. Assess the adequacy, efficiency, and effectiveness of the department's organizational structure, systems, procedures, and practices over the procurement of its goods and services.
3. Make recommendations as appropriate.

Scope and Methodology

We examined the procurement of goods and services by the Department of Health for fiscal years ended June 30, 2012, and June 30, 2013. Our examination included the department's Family Health Services Division, Emergency Medical Services and Injury Prevention System Branch, Adult Mental Health Division, Alcohol and Drug Abuse Division, and Environmental Management Division.

We procured the services of a certified public accounting firm, KMH LLP, to conduct the examination. The firm evaluated DOH's procurement organization, policies, procedures, and internal control structure to identify any deficiencies or weaknesses and made recommendations for improvement. The firm also interviewed departmental personnel involved in procurement, including those responsible for management and oversight, and observed the department's procurement procedures and activities. The firm tested 60 procurement transactions, including 35 competitive purchases of services, 12 exempt purchases of services, three restrictive purchases of services, five small purchases, three competitive sealed proposals, one procurement that was exempt from Chapter 103D, HRS, and one competitive sealed bid.

During the planning stage of the examination, we met with the department to discuss the examination's objectives and approach. DOH management shared its past problems, which included excessive time lapsing between contract award and execution. The department is not alone in this issue. In 2011, the state comptroller established a prompt payment task force. The task force in turn established a working group to address streamlining the contracting process. Prior to the working group's efforts, state contracting averaged 180 days, and it was not unusual for contracts to take more than 360 days to process. The

working group found that DOH executed the same type of contracts inconsistently. As a result, DOH hired a vendor to develop a web-based program called Contract GENie, which was mentioned in the working group's December 2013 report, to address this issue. Contract GENie has been piloted with Chapter 103F, HRS, contracts for the Behavioral Health Administration. According to DOH, there has been marked improvement in contract processing times and the department will be implementing Contract GENie in other divisions. We therefore excluded the contract processing portion of the procurement process from our examination.

When conducting interviews in the Environmental Management Division, we encountered a branch where almost all employees related to the procurement of a specific contract no longer work for the department. This limited our ability to ascertain the reasons for certain procurement decisions made for the particular contract and forced us to rely on second-hand accounts from current employees and available documentation.

KMH LLP conducted the examination from September 2014 through January 2015 in accordance with generally accepted government auditing standards. Those standards require that work be planned and performed to obtain sufficient and appropriate evidence to provide a reasonable basis for findings and conclusions based on objectives. We believe that the evidence KMH obtained provides a reasonable basis for our findings and conclusions based on the examination's objectives.

Chapter 2

Lack of Procurement Controls Exposes Health Department to Waste and Abuse

The Department of Health (DOH) has a broad mission to protect and improve the health and environment for all people in Hawai‘i. Its responsibilities range from initiatives to prevent disease and injury to promoting and facilitating recycling efforts. In carrying out its mission, the department, which is responsible for almost \$660 million in annual expenditures, has chosen to decentralize its procurement functions. However, we found this decentralized procurement system lacks clarity, consistency, and oversight. The director of health has delegated procurement authority to her division staff, who make purchasing decisions with little departmental support and minimal oversight. While this strategy may provide flexibility in purchasing, a lack of organizational control over its procurement functions puts the department at significant risk of waste and abuse.

The most glaring example of the department’s lack of control over procurement is its 2009 contract with Grant Thornton LLP/PKF Pacific Hawai‘i LLP (PKF). The contract was executed to audit certified redemption centers in the department’s Deposit Beverage Container (DBC) Program. Originally bid at \$76,400, the contract grew to \$543,374—a 611 percent increase—while its scope shrank and the deliverables’ deadline were extended by a year. In the end, the two audits the department received, which was the result of a significantly flawed procurement process, was of little value. At the time of our fieldwork the department had yet to resolve its contract issues with PKF. The department has paid PKF approximately 97 percent of the contract; however, since the contract was so poorly executed, the State is unable to seek restitution.

Summary of Findings

1. Insufficient clarity regarding roles, responsibilities, and accountability has resulted in inconsistencies, inefficiencies, and noncompliance in the Department of Health’s procurements.
2. The department provides little support to and minimal oversight of staff responsible for carrying out departmental procurements. The department’s contract with Grant Thornton LLP/PKF Pacific Hawai‘i LLP exemplifies this.

**DOH's
Decentralized
Procurement
System Lacks
Adequate
Oversight
and Clarity on
Responsibilities,
Resulting in
Inconsistent
Procurement
Practices**

Procurement as a process involves a number of steps that include planning and identifying requirements, developing specifications, soliciting and evaluating bids, awarding and administering contracts, and evaluating contractors. For the department's procurement process to be effective there must be cooperation, understanding, and commitment to the various components of the process by the Administrative Services Office (ASO) and divisional staff involved in procurement. We found two material weaknesses in the department's internal controls over the procurement of goods and services. A material weakness, as defined in *Government Auditing Standards*, is a significant deficiency or a combination of significant deficiencies in internal controls such that there is a reasonable possibility that a material noncompliance with specified requirements will not be prevented, detected, or corrected in a timely manner.

First, the department's decentralized procurement system does not provide adequate oversight over the procurement process; the resulting overreliance on individual staff has led to inconsistent procurement practices. Second, the department lacks specific guidance on procurement roles, responsibilities, and accountabilities, which has resulted in inconsistencies and inefficiencies in procurements, and noncompliance with statutory requirements.

Department provides little support for and minimal oversight of staff involved in procurements

Oversight is an essential component in an overall control framework. In this case, oversight means effectively servicing and facilitating divisions' and branches' procurement needs using clear policies, processes, and guidelines. With the diversity of its programs, the department's delegation of procurement functions to division staff is understandable. However, we found there is minimal oversight over these staff and no process to provide them with procurement service support. The ASO reviews procurement contracts, but its duties are narrowly focused on ensuring documents adhere to a correct format.

When a procurement issue arises, staff do not have clearly defined procedures for how they should obtain technical assistance. Some staff consult with the ASO, while others go directly to the Department of the Attorney General or SPO for advice. In addition, the department does not systemically review procurement activities to monitor and promote compliance to ensure that all staff adhere to key procurement requirements, particularly contract administration. This scarcity of oversight and support exposes the department to risks that purchases will not meet state procurement requirements and jeopardizes the department's assurance that it is receiving what it has paid for.

Lack of specific procurement roles, responsibilities, and accountability has resulted in inconsistencies, inefficiencies, and noncompliance

The department relies on the SPO's statewide rules and guidance and does not have its own policies and procedures regarding procurement. Although SPO provides general guidance on initiating contracts and purchase requests, it does not provide details on specific responsibilities and procedures for those involved in procurements. For a procurement process to be effective, the authority, duties, and responsibilities of those involved in procurements must be clearly defined, understood, and agreed by all parties. In addition, clear accountability should be established for each step in the process.

We found that only one of the five divisions we reviewed has a procedures manual for evaluating and monitoring contracts. Consequently, monitoring practices among divisions were generally informal and vastly inconsistent. We also found there is no oversight of contract administrators or a periodic and systematic review to ensure that functions are being conducted appropriately. Of 55 contracts we reviewed, nine did not have completed monitoring reports. In two cases, staff incorrectly believed that monitoring was not required; for the remaining seven contracts, staff blamed the lack of contract monitoring on a shortage of staff resources.

We also found that the department did not have documentation of when proposals were received for eight of 40 contracts we tested (20 percent). Staff told us that these receipt-date documents may have been misplaced. For one contract, the proposal's receipt date was *after* the proposal deadline. We were informed this was caused by a clerical error. Proper documentation of proposal receipts is important evidence in supporting that a department is maintaining a fair and open competitive environment. Diligence in documenting, and retaining such documentation, is important to avoid additional costs and time delays that can result in the case of a protest by a bidder.

We also found that one of five small purchases we tested was not posted to the online procurement awards, notices, and solicitation system. SPO's Procurement Circular 2012-04 and Hawai'i statutes require that awards of goods, services, construction, and health and human services be posted within seven days of the award.

Furthermore, the department was unable to provide a log of contracts for the fiscal years under examination with contract amounts or a list of small purchases made during that period. Although the ASO was able to compile contract amounts and find an alternative method of selecting small purchases, maintaining a log of contracts is important for monitoring the procurement process. Without adequate and timely information on all procurements, the department is unable to identify high-risk areas or unusual procurement activity. Because there are no routine or systematic audits of procurement files, these and many other documentation problems go undetected by the department.

Contract for Redemption Centers Audit Exemplifies DOH's Faulty Procurement Process

The department's contract to audit redemption centers for its Deposit Beverage Container (DBC) Program epitomizes the flaws in its decentralized procurement process. We found there were problems with the contract's procurement from the start and that the department proceeded with the procurement despite numerous irregularities. We also found that modifications to the contract drastically increased its amount, extended the deliverables deadline, and reduced the scope of work required.

In October 2008, the department sought a contractor to audit six certified redemption centers in the DBC Program. The contract was solicited and awarded via a request for proposals (RFP), which is designed to solicit multiple bidders. However, only one bid was received, and the contract was renegotiated with the sole bidder from \$76,400 to \$340,000 (an increase of 345 percent). Over the next three years, the contract was amended three times, increasing the total award to \$543,374 (611 percent above the original bid), extending the contract by one year, and reducing the number of redemption centers to be audited from six to two. The department eventually accepted the first redemption center audit report but rejected the contractor's draft of the second. However, since the contract's procurement was fundamentally and significantly flawed, we question the value of either audit effort.

The department's mismanagement in procuring the redemption center audits contract illustrates the inherent and significant weaknesses of its decentralized procurement system. On multiple occasions—from the unauthorized bid renegotiation, to the contractor's change of legal identity, to the multiple contract modifications—even minimal review and oversight would have detected numerous procurement violations and irregularities.

Evaluation committee members were unqualified and RFP omitted critical information

The redemption centers audit had multiple procurement problems from its inception. To begin with, the evaluation committee members responsible for procuring the audit did not have sufficient technical knowledge. Only one member had an accounting background. However, this person, who was an accountant in the DBC Program and was mainly involved in small purchases and processing payments, was not familiar with auditing. The committee's lack of expertise with auditing may explain the numerous subsequent procurement irregularities that occurred.

For example, the evaluation committee failed to include a scope of services in the RFP or to link payments to completion of project milestones. Creating this relationship would have been a key contract

management tool enabling the department to track the contractor's progress and limit its own exposure to risk. The committee also neglected to mention in the RFP the standards required of the contractor when performing the audits, which would have avoided any misunderstanding regarding auditing procedures to be performed or how results were to be reported. In addition, the committee chose to procure the audit contract using the competitive sealed (goods and services) proposal process (also known as an RFP) instead of the more common professional services method, which is frequently used to procure audit services.

Department proceeded with procurement despite numerous irregularities

The department's failure to ensure proper oversight of its procurements is embodied in the numerous irregularities that took place in procuring the redemption centers audit. We found that the department ignored SPO's ruling and declined to resolicit the contract; the single bidder negotiated a contract more than triple its initial bid; and the department proceeded to execute a contract with a different legal entity than the firm it evaluated, selected, and awarded the contract to.

DOH ignored SPO's ruling, declining to resolicit

In October 2008, the department advertised its RFP for the audit of DBC Program redemption centers. Only one bidder, Grant Thornton LLP (Grant Thornton), responded during the 30-day solicitation period. On March 3, 2009, the department asked SPO to approve its renegotiating with Grant Thornton without resoliciting the bid. The department wrote that resoliciting the RFP "would likely be futile" because the original 30-day advertisement had only resulted in one response.

SPO disagreed with the department and denied the request. In its March 9, 2009, response SPO said, "There is no evidence to support the department's contention that a re-solicitation would be futile, not resulting in additional competitive bids." SPO suggested the department resolicit the RFP with clearer specifications, or use the professional services method in accordance with state law. However, the department ignored SPO's ruling and suggestions, and continued with the procurement.

Single bidder negotiated a contract 350 percent higher than its bid

On March 10, 2009, Grant Thornton submitted a best-and-final offer of \$340,000—345 percent higher than its original bid of \$76,400. Grant Thornton cited three reasons for the increase: (1) it was the first audit of the redemption centers, so numerous findings were anticipated; (2) additional time was needed to document Grant Thornton's understanding

of the DBC Program; and (3) difficulty in estimating the time needed to perform the audit testing. In addition, in June 2009, Grant Thornton requested amendments to the RFP's general terms and conditions. A majority of those requests were approved by the department, and on July 22, 2009, the department awarded the contract to Grant Thornton for \$340,000.

DOH executed contract with different legal entity than it negotiated and awarded contract to

Most alarming is the fact that the department negotiated with and awarded the contract to one firm (Grant Thornton) but executed a contract with another firm. On July 19, 2010, a few days before the department awarded the contract to Grant Thornton, Grant Thornton informed the department that four days earlier it had entered into an agreement to sell its assets in Hawai'i to PKF Pacific Hawai'i LLP (PKF). Although the new firm retained all 50 of Grant Thornton's employees, the two entities were legally separate. Nevertheless, the department proceeded to execute a contract with PKF, and on August 9, 2010, issued a notice to proceed to PKF.

As it turns out, in September 2009, Accuity LLP (Accuity), another independent accounting firm, informed the department of its interest in bidding on the redemption center audits if the department would consider using the professional services method of procurement, as the SPO had suggested more than six months earlier. Accuity explained it had been unable to bid on the RFP because it was solicited under the goods, services, and construction classification, which contains an indemnification provision that impaired the firm's independence. Unlike Grant Thornton, Accuity had an understanding of the DBC Program, since it had audited the department for several years. Accuity's request to the department, however, came a month after the department had already awarded the contract.

Department agreed to nearly double the contract price, drastically extend the deadline for deliverables, and cut the deliverables by two-thirds

The department's faulty procurement process—specifically, its lack of oversight and its resulting inconsistent practices—is illustrated in the numerous amendments to the redemption centers audit contract. We found that the department increased the contract by 60 percent, extended the deadline for deliverables by a year, and reduced the deliverables from six to two. In the end, the department received two deliverables that were of little value, but had already paid the contractor 97 percent of the contract amount.

Significant changes were made to the contract

In February 2011, six months after issuing the notice to proceed, the department modified the redemption centers audit contract by increasing the contract amount from \$340,000 to \$543,374—a 60 percent increase, and 611 percent over the original bid for the project.

Six months later, in August 2011, the contract was modified again. This time the department extended the deadline for delivery of the audits by a year, from August 2011 to August 2012.

In November 2011 the contract was modified for a third time, reducing the number of audits to be performed from six to two—thereby effectively tripling the cost of each audit, from about \$90,000 to more than \$271,000.

End products were of little value

In September 2011, the first of the two audits, *Report to the State of Hawai‘i Department of Health on the Program and Compliance Audit of Reynolds Recycling, Inc.*, was released by the department. In the report’s scope and methodology section, PKF wrote, “Our work did not constitute an audit conducted in accordance with generally accepted auditing standards....” PKF did not explain what standards it did follow for its sampling methodology, or how the project changed from a “financial and compliance audit” as advertised in the RFP to a “program and compliance audit” in the final report.

In February 2012, PKF submitted a draft of its second report, *Report to the State of Hawai‘i Department of Health on the Program and Compliance Audit of RRR Recycling Services Hawai‘i*. The current solid waste coordinator was concerned the report did not meet the department’s stated objectives. Specifically, the report did not cite which, if any, auditing standards were followed; there was no justification for the sample sizes; and PKF had changed its testing procedures after completing 1,500 hours of work. PKF was unable to address these issues to the department’s satisfaction, so the department withheld further payment. However, by then the department had paid PKF \$525,051—about 97 percent of the total contract.

The Solid and Hazardous Waste Branch chief acknowledged that in retrospect he relied too much on the previous solid waste coordinator and solid waste planner to properly procure and manage the redemption centers audit contract. The branch chief said he would not have approved the first amendment, cutting the department’s losses.

Conclusion

The department's decentralized procurement system lacks adequate oversight of and clarity on responsibilities to staff involved in procurements, resulting in inconsistent procurement practices between various divisions and branches. These deficiencies put the department at risk that procurements are not made in accordance with state law and jeopardize the department's assurance that it receives what it has paid for. The department's contract with Grant Thornton/PKF illustrates what can go wrong when procurement efforts do not have proper guidance, support, and oversight. At multiple points in the procurement of that contract, even minimal review and oversight would have detected procurement violations and irregularities. The department ultimately paid more than half a million dollars for a single audit report that, in the end, was of little value. Because there are no department-wide support or oversight functions, the department has no way of knowing how many contracts like the Grant Thornton/PKF contract it has procured. More importantly, the department has no way of ensuring that such problem-filled procurements do not occur again.

Recommendations

1. The Department of Health should improve its procurement practices by:
 - a. **Increasing organizational oversight over procurements.** Depending on the nature and type of contract, method of procurement, complexity of procurement, composition and technical knowledge of the evaluation committee and staff involved in the procurement, and risks of fraud, transparency, and noncompliance related to the procurement:
 - i. The Administrative Services Office should provide greater oversight over departmental procurements by defining what oversight responsibilities the ASO will provide, including determining the level of review and approval required for solicitations and awards that are deemed high risk; determining whether an evaluation committee has the appropriate knowledge, expertise, and composition reflective of the complexity and dollar value of the procurement; determining the level of review and approval required for significant contract modifications; identifying what its technical support will be and what role the State Procurement Office should have in conjunction with ASO oversight; notifying departmental divisions, branches, and offices of any procurement violations or noncompliance; and enforcing any corrective actions; and

- ii. The department should develop a periodic, systematic review of procurement activities to monitor and promote compliance and ensure that all employees involved in procurements adhere to key requirements, including contract administration.
- b. **Clarifying roles, responsibilities, and procedures for procurements** by:
 - i. Developing and implementing a department-specific procurement policy and procedures manual that defines roles, responsibilities, authority, and accountability for each step in the procurement process. The manual should include specific guidelines, instructions, and standards for acquisitions of products and services. It should explain how to handle key issues and mistakes in the procurement, contract administration, and quality assurance processes, detailing procurement controls and oversight responsibilities. The manual should be formally approved by management and periodically reviewed and updated; and
 - ii. Identifying and communicating what constitutes a high-risk procurement that should be referred to ASO for guidance. Risk factors include contracts where the procurer does not have technical expertise or past experience with what is being procured, unusual contract terms or circumstances, and bid protests.
- 2. The director of health should ensure that staff involved in procurements are adequately trained and appropriately supervised.
- 3. The department should review its procurement of the Grant Thornton/ PKF contract. If the department determines that a procurement violation has occurred, it must report this violation to the SPO and rectify its process to ensure such a violation does not occur in future.

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Chapter 3

Independent Accountant's Report on Internal Controls

This chapter presents the independent accountant's report issued by KMH LLP on the internal controls over compliance for the Department of Health's procurement of goods and services for the fiscal years ended June 30, 2012, and June 30, 2013.

Independent Accountant's Report

We examined the effectiveness of the State of Hawai'i, Department of Health's internal controls over compliance for the procurement of goods and services for the fiscal years ended June 30, 2012, and June 30, 2013. The department's management is responsible for maintaining effective internal controls over compliance for the procurement of goods and services. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and the standards applicable to attestation engagements contained in the *Government Auditing Standards* issued by the Comptroller General of the United States, and, accordingly, included obtaining an understanding of the department's internal control over compliance for the procurement of goods and services; testing and evaluating the design and operating effectiveness of the internal control; and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations, internal control over compliance for the procurement of goods and services may not prevent or detect and correct material noncompliance. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

We identified two findings: (1) the lack of defined oversight and (2) the lack of specific procurement roles, responsibilities, and accountability over the department's procurement process. We believe such conditions are material weaknesses. A material weakness is a condition that precludes an entity's internal control from providing reasonable assurance that material noncompliance with a specified requirement will not be prevented or detected on a timely basis.

In our opinion, because of the effect of the material weaknesses described in Chapter 2 of this report on the achievement of the objectives of the control criteria, the department has not maintained effective internal control over compliance for the procurement of goods, services, and health and human services for the fiscal years ended June 30, 2012, and June 30, 2013, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

The report is intended solely for the information and use of the State Auditor, the Hawai'i State Legislature, and the department's management and is not intended to be, and should not be, used by anyone other than these specified parties.

/s/ KMH LLP

Honolulu, Hawai'i
June 30, 2015

Response of the Affected Agency

Comments on Agency Response

We transmitted a draft of this report to the Department of Health on July 14, 2015. A copy of the transmittal letter is included at Attachment 1. The department's response dated and received on July 22, 2015, is included at Attachment 2.

In its response to the audit, the department did not dispute our findings or recommendations. In order to better clarify roles, responsibilities, and procurement procedures, it will be forming an internal procurement working group to further assess its current decentralized system. While it acknowledged that its contract with Grant Thornton LLP/PKF Pacific Hawai'i LLP had problems, it did not believe that its procurement and monitoring of this contract accurately reflects the department's procurement practices as a whole. However, it will utilize the findings of the audit to improve future contracts and avoid repeating past mistakes.

ATTACHMENT 1

STATE OF HAWAII
OFFICE OF THE AUDITOR
465 S. King Street, Room 500
Honolulu, Hawaii 96813-2917



JAN K. YAMANE
Acting State Auditor
(808) 587-0800
FAX: (808) 587-0830

July 14, 2015

COPY

The Honorable Virginia Pressler, M.D.
Director
Department of Health
1250 Punchbowl Street
Honolulu, Hawaii 96813

Enclosed for your information are three copies, numbered 6 to 8, of our confidential draft report, *Lack of Procurement Controls Exposes Health Department to Waste and Abuse: Procurement Examination of the Department of Health*.

We ask that you telephone us by Thursday, July 16, 2015, on whether or not you intend to comment on our recommendations. If you wish your comments to be included in the report, please submit your hard copy response to our office no later than 12 noon, Wednesday, July 22, 2015.

Since this report is not in final form and changes may be made to it, access to the report should be restricted to those assisting you in preparing your response. Public release of the report will be made solely by our office and only after the report is published in its final form.

Sincerely,

A handwritten signature in cursive script, reading "Jan K. Yamane".

Jan K. Yamane
Acting State Auditor

Enclosures

DAVID Y. IGE
GOVERNOR OF HAWAII



VIRGINIA PRESSLER, M.D.
DIRECTOR OF HEALTH

STATE OF HAWAII
DEPARTMENT OF HEALTH
P. O. BOX 3378
HONOLULU, HI 96801-3378

In reply, please refer to:
A/16-001

July 22, 2015

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OFF. OF THE AUDITOR
STATE OF HAWAII

Ms. Jan Yamane
Office of the Auditor, State of Hawaii
465 South King Street, Suite 500
Honolulu, Hawaii 96813

Dear Ms. Yamane:

Attached are the Department of Health's comments for the Procurement Examination of the Department of Health for the fiscal years ended June 30, 2012, and June 30, 2013.

We appreciate the opportunity to comment on the audit report.

Sincerely,

Virginia Pressler, MD
Director of Health

Attachment

SUBJECT: PROCUREMENT EXAMINATION FOR THE DEPARTMENT OF HEALTH FOR FISCAL YEARS ENDING JUNE 30, 2012, AND JUNE 30, 2013

The Department of Health (DOH) appreciates the opportunity to comment on the subject report. We recognize that the audit is a management tool to identify shortcomings and areas for improvement. DOH will work diligently on the deficiencies outlined in the audit report and consider how best to improve oversight, consistency, and efficiency in its procurement processes.

We offer the following specific comments on the recommendations made in the report:

The DOH should improve its procurement practices: Increasing organizational oversight over procurements.

The DOH Administrative Services Office (ASO) currently provides departmental review and approval on all 103D and 103F solicitations through their pre-audit and contracts sections. Procedures are in place for programs to submit all procurement documents through the ASO for review prior to procurement.

As the audit notes, DOH has decentralized much of the procurement review to its various programs. DOH maintains a wide range of program responsibilities and, in addition, must support many changes within its programs and organization structures. One of the more effective methods to disseminate pertinent information from ASO to the programs is through an intranet system, where the latest information and guidance can be readily available. DOH also supports programs work with SPO and their assigned deputy attorney general on procurement related matters to draft procurement related documents and pre-approved scopes of services. Monitoring and compliance has been done at the division level and at times by the funding agency by reports and audits. Although contracts over a specified dollar amount and approved by the Attorney General are filed at ASO, management and monitoring of the contract has been conducted by the programs. DOH has been audited annually and the audit review has included contracts, small purchases and leases.

DOH acknowledges that additional measures can be taken to improve oversight, consistency, and efficiency in its procurement processes. DOH will consider how best to improve oversight, particularly for solicitations and awards that are deemed high risk in terms of nature of the scope of work and contract value. DOH will make an increased effort to ensure programs are in compliance with procurement rules and requirements.

The DOH should improve its procurement practices: Clarifying roles, responsibilities, and procedures for procurements.

The DOH currently posts procurement procedures on the DOH Intranet which are accessible to all DOH staff. Flow charts, checklists, policies and procedures, samples, and templates are posted on the intranet for program use. The information available on the intranet is taken from the State Procurement Office's (SPO) website. All staff participating in procurement must first go through SPO's training classes or webinars, be certified by the Procurement and Supply Specialist, and obtain authorization to log-in to the SPO site to start the procurement process.

Please note that the state system does not currently have at the program level position classifications that specifically focus on procurement roles and responsibilities. Without such a position classification, the DOH is limited in hiring staff whose primary focus is on contract solicitation and administration. This limits the DOH's ability to centralize its review. DOH has used the Public Health Administrative Services

Officer position classification and has incorporated procurement responsibilities within these positions across the department.

DOH is committed to better clarifying roles, responsibilities and procurement procedures. We will be forming an internal procurement working group to further assess our current decentralized procurement system, including both contract solicitation and contract administration efforts, and to identify areas of strength as well as areas of improvement. The working group will include DOH staff actively involved with various types of procurement (subject matter experts), SPO staff and representatives from the Attorney General's Office. The working group will also be asked to address the need to develop additional DOH specific procurement procedures as well as implement regular periodic reviews and updates of these department-wide procedures. This is similar to a process that DOH has implemented in formulating improvement efforts in the contract development and execution process that the DOH has successfully implemented and is currently expanding department-wide.

The Director of Health should ensure that staff involved in procurements are adequately trained and appropriately supervised.

The DOH has used a de-centralized procurement system and the online on-demand SPO training offered to keep the department's staff up to date on procurement procedures. In order to do a procurement, DOH staff must take on-line classes through the State Procurement Office (SPO), be certified by ASO, and must be authorized to log into the SPO website before posting solicitations. In 2005, the ASO Contract Section conducted a training which included a comprehensive training manual. To help the programs keep up with changes in forms and the State's shift toward an electronic system, ASO created an intranet based website to organize the 13 procurement types plus Memorandum of Agreements (MOA), Supplemental Contracts, and other types of agreements by creating procurement flow charts, checklists, links to the State Procurement Office website, samples, Comptroller memos, ASO memos, Budget Execution policies, and various documents on its intranet to help programs in the solicitation and contracting process. This contract website is frequently updated.

Additionally, the ASO offers formal training to all programs periodically on various procurement topics as well as informal trainings to specific programs where need dictates. The department has relied on the administrative staff at the program level to appropriately supervise staff providing contract origination and monitoring.

The DOH is committed to improving the training and supervision of staff involved in procurements and will focus on areas of weakness identified in this audit.

The Department should review its procurement of the Grant Thornton/PKF contract.

The DOH acknowledges again that there should have been closer supervision in the origination and particularly the subsequent monitoring of changes to this contract. We recognize that the RFP specifications lacked clarity, appropriate auditing standards, and clearly defined deliverables identified within the requested scope. While there were clearly problems with DOH's procurement and monitoring of this one contract, it is neither accurate nor fair to extrapolate from these legitimate concerns and generalize about all of DOH's procurement practices.

The DOH made an effort to work with Grant Thornton and PKF to address the DOH's auditing needs and negotiated in good faith with licensed Certified Public Accountants (CPAs) for auditing services. CPAs have a fiduciary duty to provide honest advice and services to their clients. The DOH relied on its auditor, PKF, to do an audit based on the rules, regulations and HRS which created the Deposit Beverage Container program. Since the Deposit Beverage Container program was relatively new and there was

staff turnover, there was insufficient expertise at the program level during that time period to conduct an audit internally, hence, the decision to procure a contract for a licensed auditing firm.

The DOH would like to provide comment on some of the representations made in the report regarding the contract with PKF:

Evaluation committee members were unqualified:

The evaluation committee, approved by the Director of Health, was comprised of the following: Solid Waste Management Coordinator, Public Health Administrative Officer VI, Accountant IV and Planner IV. The job duties and responsibilities of these staff include fiscal, administrative, and program expertise. These committee members were not unqualified. The DOH, however, acknowledges that because the program had never before procured this type of contract, it should have included at least one additional committee member with technical expertise in procuring audit type services.

Procurement of audit services is a unique service area. And since the State Auditor's Office is the primary entity that oversees and procures audit services for the State, DOH strongly recommends that a representative from the State Auditor's Office be available to provide departments with technical assistance and guidance on procuring audit services, be open to participate in procurement selection committees for audit services, and consider developing an audit provider listing of companies and firms that meet minimum industry standards.

The DOH ignored SPO's ruling, declining to re-solicit:

The DOH did not ignore SPO's ruling, but attempted an alternative procurement method (SPO-15). The program posted the RFP on the correct website for more than thirty days, which it felt was an appropriate amount of time. In hindsight, re-solicitation would have been prudent.

Single bidder negotiated a contract 350 percent higher than its bid:

The DOH acknowledges in hindsight that the RFP scope should have included clear goals and outcomes. The RFP was vague, and therefore, required additional discussion to determine the proper scope of the audit work. While a re-solicitation was not necessarily required, given the vagueness of the RFP, it would have been prudent to re-solicit.

DOH executed contract with different legal entity than it negotiated and awarded contract to

In 2010, one year after the DOH awarded the contract to Grant Thornton (GT), the DOH was informed by letter that Grant Thornton's assets in Hawaii were sold to PKF Hawaii LLP (PKF). The letter, signed by GT's West Region Managing Partner, assured the DOH that PKF had purchased the majority of GT's clients, assumed its office space in Honolulu, and hired its current employees. DOH then executed a contract with PKF, which was signed by Patrick Oki as PKF's managing partner. Mr. Oki had been with GT's Audit and Advisory Services, and as a partner with GT, he had submitted the best and final offer on behalf of GT. Mr. Oki provided the DOH with a copy of the Department of Taxation's Report of Bulk Sale or Transfer (Form G-8A). This form and the letter from GT announcing the sale of the company to PKF was an acceptable way to document the change in ownership, and an executed contract under PKF Pacific Hawaii LLP was submitted and accepted by the Department of Accounting and General Services.

Significant changes were made to the contract:

It is true that significant changes were made to this contract. Changes were necessary, in large part, because of the vagueness in the original solicitation, which was caused by the new program's lack of

experience in procuring auditing services. When the program better realized what was required, it realized that modifications were needed. DOH concedes that it should have better anticipated what programmatic needs were required and should have monitored subsequent changes better.

However, it is not accurate to conclude simply that DOH reduced the scope of the audits by two-thirds when the third modification required auditing of only two companies instead of the original six. Rather, DOH decided it would be more efficient to refocus the audits on the two largest companies, which operated 57 of the 87 recycling redemption centers (66% of total) and receive almost 50% of the refunds paid by the DOH based on Deposit Refund Request (DR-1) and Handling Request (HR-1) forms that needed to be audited. Also, the forms being audited were all handwritten, which made the auditing more difficult and time consuming in terms of verification and authenticity.

End products were of little value:

We acknowledge that the value of the delivered products was less than expected and limited by the lack of supporting data. However, it is not accurate to say that the reports were of no value to DOH.

The report correctly notes that virtually all of the employees involved in the subject Deposit Beverage Container contract no longer work for the department. This lack of institutional knowledge combined with minimal documentation has made it very difficult for current DBC program staff to understand or learn from previous work efforts, good or bad. Moving forward, the DBC program will utilize the findings of the audit and commit to improving future contracts and avoid repeating past mistakes. We will seek input from other agencies and personnel familiar with conducting or contracting for audits, such as the Office of the State Auditor, before attempting future audits. Finally, the DBC program will establish and fill the two Accountant III and one Account-Clerk positions with the ultimate goal of developing the internal capability to conduct audits of certified redemption centers.