California State Auditor

BUREAU OF STATE AUDITS

Department of Rehabilitation:

Poor Management Practices Limit the Effectiveness of the Business Enterprise Program for the Blind

August 1997
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CALIFORNIA STATE AUDITOR

KURT R. SJOBERG
STATE AUDITOR

MARIANNE P. EVASHENK
CHIEF DEPUTY STATE AUDITOR

August 27, 1997 96031

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As required by Section 19640.5 of the California Welfare and Institutions Code, the Bureau of State Audits presents its audit report concerning the Department of Rehabilitation's (department) administration of the Business Enterprise Program for the Blind (program). This report concludes that poor management practices limit the effectiveness of the program.

Specifically, the department should provide increased opportunities for vendors to operate more profitable vending locations. Also, the department needs to more effectively fulfill its responsibilities in providing vendor advice and assistance through its ongoing training program and consulting services. In addition, the department should improve its administration of program finances by ensuring that the vendors are submitting their monthly reports and fees as required, delinquencies are promptly addressed, and vending machine commissions are collected and used appropriately. Further, to minimize the potential financial risk to both the vendors and the State, the department should work to resolve the issues surrounding the retirement plan as quickly as possible and perform a thorough review of the status of the vendors as state employees or independent contractors.

Respectfully submitted,

KURT R. SJOBERG
State Auditor

BUREAU OF STATE AUDITS
660 J Street, Suite 300, Sacramento, California 95814 Telephone: (916) 445-0255 Fax: (916) 327-0019

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Audit Highlights . . .

The department's poor management practices limit the effectiveness of the Business Enterprise Program for the Blind. Specifically, the department:

- ☑ ***Does not make a concerted effort to establish new, more profitable vending locations;***
- ☑ ***Is not fulfilling its responsibilities in providing vendor advice and assistance;***
- ☑ ***Needs to improve its administration of program finances; and***
- ☑ ***Has placed the vendors and the State at risk because of certain tax-status issues.***

Results in Brief

The Department of Rehabilitation (department) administers the Business Enterprise Program for the Blind (program) in accordance with the federal Randolph-Sheppard Act and the California Welfare and Institutions Code. The purpose of the program is to provide blind persons with remunerative employment, enlarge the economic opportunities of the blind, and to stimulate the blind to greater efforts in striving to make themselves self-supporting. To accomplish this purpose, the program provides training and vending facilities to enable qualified blind persons to operate their own vending businesses throughout the State.

The program is unique because it consists of numerous individual, government-sponsored businesses competing with private-sector entities for profits. Although the intent of the program is to provide blind persons with meaningful business opportunities that allow them to be independent, we found that the department's administration of the program does not ensure that this objective is always met. Specifically, we noted the following conditions:

- The department is not sufficiently promoting the program to all who might be eligible and interested. In addition, the department does not make a concerted effort to establish new, more profitable locations or improve existing locations, and is slow to explore other business opportunities that would provide alternatives to the types of vending facilities currently available to vendors. Further, it does not provide vendors already in the program with an equal opportunity to apply for facilities because of its process for awarding certain locations.

- The department needs to more effectively fulfill its responsibilities to both the vendors and the Business Enterprise Consultants (BECs) who advise and assist them. For example, the department does not adequately provide training for all vendors to improve current operations or enhance their skills for more complex facilities. Moreover, the department does not always emphasize consulting services, which are designed to identify and resolve issues that negatively affect vendors' profitability. In addition, the department reduces the effectiveness of consulting services provided to vendors because it does not provide sufficient training or guidance to the BECs and it does not enforce the procedures which require BECs to conduct specific reviews of vendor performance. Further, it has not adopted procedures that compel vendors to adhere to the terms of their contracts with the department.

- The department's inadequate administration of program finances impairs the program's growth and continued viability. For example, the department does not ensure that vendors promptly submit required monthly financial reports, fees, or loan repayments. In addition, the department is inappropriately using vendor set-aside fees to provide loans to vendors. Moreover, the department has not demonstrated that it administers set-aside fees in a manner equitable to all vendors. Further, while the department has made some improvement in ensuring it receives all vending machine commissions available to the program, more improvement is needed, and the department must ensure that it uses these commissions for the benefit of all vendors in an equitable manner. Finally, the department needs to improve its controls over equipment. For example, the department has allowed a private food service company to use program equipment at a location developed for program vendors.

- The department has not promptly resolved certain tax-status issues related to the program's retirement plan, thereby putting the vendors and the State at risk. Specifically, the department has administered the retirement plan as a qualified plan for tax purposes, even though as early as 1990, a retirement consulting firm raised concerns that the retirement plan did not meet the requirements of a qualified plan. On a different matter, while the department has stated the vendors are independent businesspersons, it has put the State at risk because its administration of the program raises a question regarding whether its relationship with the vendors is more like an employer/employee relationship. If it is determined that the vendors should in fact be classified as employees, the State is potentially liable for failure to provide employee benefits and withhold taxes.

Recommendations

To ensure that it is maximizing vendor participation, the department should perform the following tasks:

- Consistently promote the program to all department counselors and initiate mailings to blind individuals and community organizations;

- Aggressively identify and establish profitable vending locations on both public and private property, combine locations when beneficial, and document the analysis performed to determine a location's potential;

- Formulate criteria and procedures for supplementing less lucrative locations and apply them consistently;

- Establish procedures to systematically study the successes of private enterprise and analyze potential lucrative business opportunities. In addition, it should consider innovative ways to implement new business opportunities; and

- Establish procedures to circulate all vending locations to eligible vendors.

To fulfill its responsibilities in providing vendor advice and assistance, the department should take the following steps:

- Ensure that the curriculum for its ongoing training program provides opportunities for all vendors to improve their skills in operating vending facilities and consult with vendors to develop ongoing training classes that meet their needs;

- Enforce state regulations and contract requirements which direct vendors to submit profit and loss statements and maintain adequate supporting documentation;

- Establish clear policies and procedures, and provide adequate guidance and training to ensure that BECs are able to perform adequate consulting services, including profit and loss reviews, vendor appraisals, reviews of locations, and counseling of vendors who are not complying with the terms of their contracts;

- Re-evaluate the use of BECs to provide equipment services, with the goal of optimizing the time available for adequate consulting services; and

- Modify vendor contracts to include ranges of acceptable performance, uniformly enforce contract terms, and suspend or terminate the licenses of those vendors who fail to respond to counseling and continue to disregard the contract terms.

To improve its administration of program finances, the department should take the following actions:

- Promptly follow up on missing monthly vendor reports and improve its monitoring of delinquent accounts receivable;

- Ensure that it appropriately administers and collects set-aside fees in an equitable manner and in accordance with federal law and regulations;

- Vigorously attempt to collect all outstanding loans that were inappropriately disbursed using set-aside fees and reimburse the trust fund for moneys used for these loans;

- Improve its collection of vending machine commissions by contracting with vending machine companies and monitoring compliance;

- Appropriately use vending machine commissions to benefit all vendors in an equitable manner;

- Discontinue the practice of allowing a private food service company to use equipment purchased with federal funds and collect the money that is owed it; and

- Promptly reconcile the results of its physical inventories with equipment records.

To minimize the potential financial risk to both the vendors and the State, the department should take the following actions:

- Work to resolve the retirement plan issues as quickly as possible; and

- Perform a thorough review of the status of the vendors as state employees or independent contractors and implement those modifications that will ensure that vendors are treated as intended.

Agency Comments

The department states that, based on principles of sound public policy regarding the appropriate use of limited resources, it disagrees with many of the findings and conclusions in the report. The department acknowledges that there are problems within the program and believes that changes to the program as a result of certain audit findings will prove to strengthen it. On the other hand, the department believes that many of the findings and recommendations, when viewed from an overall public policy perspective, illuminate the problems inherent in a program it considers to be outmoded and out of step with the impending 21st century. Our comments on the department's response immediately follow it.

Introduction

Background

The Department of Rehabilitation (department) administers the Business Enterprise Program for the Blind (program) in accordance with the federal Randolph-Sheppard Act and the California Welfare and Institutions Code. The purpose of the program is to provide blind persons with remunerative employment, enlarge the economic opportunities of the blind, and to stimulate the blind to greater efforts in striving to make themselves self-supporting. To accomplish this purpose, the program provides training and vending facilities to enable qualified blind persons to operate their own vending businesses throughout the State. As of January 1997, the department was providing rehabilitative services to approximately 5,000 blind individuals, with approximately 180 participating in the program.

Vendors' Participation in the Program

Interested clients are referred to the program by the department's counselors. Upon acceptance, the department provides these clients with a comprehensive six-month food service training course. Once they have successfully completed the course, the department licenses them as vendors. The vendors then apply to operate a vending facility, such as a cafeteria, snack bar, wet or dry vending stand, or vending machines. After a vendor has been awarded a location, the program assists the vendor by paying for equipment and certain start-up costs necessary to run the facility. The program continues to serve the vendors while they remain active in the program, procuring and repairing equipment, as well as providing consulting services. Finally, the vendors may voluntarily participate in a retirement plan.

Funding for the Program

The program derives its funding from federal funds, the State's General Fund, vendor fees and contributions, and vending machine commissions. Federal funds provide for the purchase of new and replacement equipment, initial stock and supplies for a facility, and management services of the department. For costs allowed under federal guidelines, the federal share is approximately 80 percent. Depending on the nature of the expense, the remaining 20 percent is provided either by the State's General Fund or by vending fees, which are funds set aside from the net income of vending operations.

As of April 1997, the balance of the funds set aside in the Vending Facilities Trust Fund was approximately $3.9 million. These moneys are used for maintenance and replacement of equipment, purchase of new equipment, management services, and payment of various vendor benefits. The program also receives commissions from vending machines located on state and federal property within California. This income is either distributed to vendors or used to fund the department's contributions to the vendor retirement plan.

The Role of the California Vendors Policy Committee

In accordance with federal regulations, the department, as the state licensing agency, has established the California Vendors Policy Committee (committee) to represent the blind vendors in the program. The duties of the committee include actively participating with the department in major policy and program decisions affecting the overall administration of the vending facility program, receiving and transmitting vendors' grievances to the department, and participating in the development of vendor training programs. The members of the committee are elected biennially by the blind vendors within the program.

Performance Data for California's Program

To comply with federal reporting requirements, the department submits an annual report to the federal Rehabilitation Services Administration (RSA) that details the performance of the program. The report contains information on the number of vendors within the state program, the number and types of facilities, and the average earnings of vendors. Using the reports submitted by all state programs, the RSA compiles an annual statistical report.

In the data submitted to RSA for fiscal year 1994-95, the department reported that vendors had a total net profit of $5.7 million and average earnings of $33,700. These average earnings are 28 percent above the national average earnings for vendors of $26,400. However, this is not necessarily a good measure of the profitability of the program's individual locations because a significant number of vendors in California operate more than one location.

Results of the Previous Report by the Bureau of State Audits

In August 1995, the Bureau of State Audits issued a financial report on the program. The report concluded that the financial condition of the program was sound but noted certain weaknesses in the department's internal control structure and in its compliance with certain laws and regulations. For example, we found the department:

- Did not ensure it received all monthly operating reports, fees, and loan payments due from its vendors;
- Did not ensure it received all vending machine commissions available to the program;
- Improperly used federal funds and did not accurately report its liabilities; and
- Needed to improve its controls over fixed assets and ensure the appropriate segregation of duties.

The department has not fully implemented all of the recommendations contained in the report. Appendix A identifies the department's actions on the recommendations we made.

Other Management Reports

The department has also received two other reports addressing various issues related to the program over the last six years. Specifically, in December 1991, the Graduate School of Management at the University of California, Davis completed a management study of the program. Also, in May 1993, Joseph P. Keating, a consultant, completed a report for the director of the department. The consultant concluded that the objectives of the program were not adequately met. Both these studies detailed findings and recommendations similar to those we have presented in this audit. However, we found no evidence to suggest that the department implemented any of the recommendations provided by these two reports.

Scope and Methodology

The California Welfare and Institutions Code, Section 19640.5, requires the Bureau of State Audits to conduct a financial audit of the program every third fiscal year and a programmatic review and audit every five years. As previously discussed, in August 1995, we completed a financial audit of the program. This is the first programmatic audit our office has issued in response to the statute.

We reviewed the department's compliance with federal and state laws and regulations including the Randolph-Sheppard Act in the United States Code, Title 20, Section 107; the Code of Federal Regulations, Section 34, Part 395; the California Welfare and Institutions Code, Sections 19625 through 19652; and the California Code of Regulations, Title 9, Chapter 6.

To determine whether the department is adequately promoting the program to both potential and existing clients, we conducted interviews with department staff and reviewed the promotional efforts made by the department.

To determine whether it is effectively evaluating potential vendors, we selected a sample of applicants and reviewed documents used by the department to assess their qualifications and potential for success in the program.

To assess the department's efforts to offer profitable vending locations, we reviewed the locations circulated over the last several years and determined whether these locations offered the vendors an attractive business opportunity. We also performed several site visits to assess the established locations. In addition, we selected a sample of potential vending locations and reviewed the department's analysis of each to determine whether the location represented a viable opportunity. Further, we reviewed the extent to which the department has considered new and innovative ideas for improving the program, such as up-to-date food kiosks, espresso and hot dog carts, gift shops, and convenience stores. Finally, we asked vendors whether they have adequate opportunities for transferring to better locations.

To assess the adequacy of the department's placement process, we reviewed the procedures used to award permanent and temporary locations to vendors and analyzed a vendor database, which profiles the locations the vendors operate.

To determine whether the department's training program promotes vendor success, we reviewed the curriculum. Also, we assessed the qualifications of the trainers using job specifications, duty statements, and resumes. In addition, we interviewed the trainers and sought the opinions of the vendors regarding the adequacy of the program.

To assess the consulting services provided to vendors, we conducted interviews with the department's Business Enterprise Consultants (BECs) and reviewed the department's procedure manual. We assessed the management tools that the BECs use to promote and encourage vendor success. We also reviewed the percentage of time that the consultants spend on their various responsibilities. In addition, we sought the opinions of the vendors as to the adequacy of the consulting services they received. Further, we examined the vendor appraisals and reviews of locations prepared by the BECs.

To evaluate the department's financial administration of the program, we reviewed its efforts to collect delinquent accounts receivable and vending machine commissions, administer loans, and ensure that vendors are submitting profit and loss reports. In addition, we performed aging analyses of missing profit and loss reports, delinquent accounts receivable, and delinquent loans. Moreover, we selected a sample of vendors and reviewed the corrective action taken by the department for vendors in financial trouble. Further, we assessed the adequacy of the set-aside fee schedule established by the department. Finally, we determined whether the department promptly reconciled physical inventories of equipment with property and accounting records.

To evaluate the department's efforts in administering the vendors' retirement plan, we reviewed a copy of it, as well as various documents related to its administration. We also interviewed department staff and staff of the Department of General Services.

To assess the status of the vendors as employees versus independent contractors, we interviewed department staff, reviewed pertinent documentation, and obtained an opinion from our legal counsel.

To compare the program with other similar programs, we interviewed business enterprise program staff in Florida, Illinois, Nevada, Ohio, and Texas, and obtained information regarding the administration of the program for each state.

To obtain vendor input regarding the administration of the program, we mailed a survey to all 205 licensed vendors in the State. The survey included questions addressing various aspects of the program. See Appendix B for a summary of the 117 responses that we received.

Chapter 1

The Department Is Not Maximizing Vendor Participation

Chapter Summary

The Department of Rehabilitation (department) is not sufficiently promoting the program to all who might be interested. In addition, the department does not make a concerted effort to establish new, more profitable vending locations or improve existing locations. Further, the department is slow to explore other business opportunities that would provide alternatives to the types of vending facilities currently available to vendors. Finally, the department does not provide all vendors with an equal opportunity to apply for facilities because of its interim location process. Without more aggressive efforts to improve existing facilities or establish new ones, the department restricts program growth and limits the opportunities available for qualified vendors. As a result, the department is not maximizing funding for the program and the continued existence of the program is threatened.

The Department's Promotional Efforts Are Insufficient

The department is not ensuring that blind Californians are made aware of the program.

The intent of the program, according to federal and state law, is to provide qualified blind individuals with the opportunity to become successful business people by operating vending facilities on federal and state properties. To meet the intent, the department must adequately promote the program to ensure that blind Californians are made aware of it and that those interested are given the opportunity to apply. Through adequate promotion, the department can ensure that it maximizes participation. However, the department may not be maximizing participation among clients of the department. As of January 31, 1997, approximately 5,000 blind individuals were receiving services from the department. By comparison, approximately 180 individuals were participating in the program either as licensed vendors or as trainees. The low participation rate could be a result of the department not sufficiently promoting the program.

Any blind Californian may apply for rehabilitative services from the department. The department assigns a rehabilitation counselor for the blind (RCB) to work with each individual, or if caseloads necessitate, a generalist counselor (counselor) is assigned. Once a client of the department, an individual can apply to the program for an evaluation of his or her potential to operate a vending facility. Because the program is only available to clients of the department, the department must ensure that all blind clients are made aware of the program by promoting it to the RCBs and counselors.

The department promotes the program to the RCBs and counselors primarily by mailing an information package to them at their request and discussing the program at regional RCB meetings and training for new counselors. The information package focuses primarily on the initial training course. The package contains the forms the RCBs and counselors must complete when referring a client to the program. It also contains a fairly old promotional brochure that briefly describes the program, the types of vending facilities available, and the services provided.

The department does not sufficiently promote the program within the department or to individuals and community organizations.

The department's outreach efforts do not ensure that all RCBs are aware of the program. We interviewed 5 of the 36 RCBs throughout the State and found that 1 was unaware of the program until a client requested information. This RCB had been a counselor for 4 years and an RCB for 4 months before she knew about the program. According to the program administrator, the department sends the information package to only those RCBs and counselors who request information. There are over 700 counselors throughout the State that could work with blind individuals. Because the department mails the information package only on request and there are insufficient ongoing promotional efforts, the RCBs and counselors unfamiliar with the program may remain uninformed. Therefore, by not sufficiently promoting awareness of the program to RCBs and counselors, the department cannot ensure it is reaching all potential applicants.

To maximize participation in the program, the department must also promote the program to blind individuals who are not currently clients but who may have an interest in operating a vending facility. Although the program's administrator indicated that the department promotes the program directly to blind individuals and to community organizations for blind individuals, such as the Braille Institute and the Lighthouse for the Blind, the department does not initiate mailings but only responds to requests. Like the community-based organizations, interested blind individuals who are not currently clients of the department can also request information. It is clear that the department has no direct outreach plan and relies on these contacts to promote the program's opportunities. These efforts do not ensure that all blind individuals are made aware of the program.

The Department Believes Certain Regulations Are No Longer Appropriate

The department believes that certain state regulations requiring medical and vocational evaluations for program applicants are inconsistent with federal law. As a result, the department is not complying with the regulations.

The department's Applicant Review Panel's (panel) primary function is to evaluate each applicant's potential to successfully operate a vending facility. RCBs and counselors prepare referral packages for applicants to the program. The panel reviews the referral package and interviews the applicants. It either approves applicants for one-month on-the-job training with an established vendor or refers them to an RCB or counselor for further vocational assessment. The panel approves applicants who successfully complete on-the-job training for the program's initial training course.

Federal and state regulations provide criteria that the applicant must meet to be considered qualified to operate a vending facility. To be qualified, the applicant must be blind, a U.S. citizen, not have active or infectious tuberculosis (TB), and be a client of the department. In addition, state regulations require that medical and vocational evaluations be on file with the department to indicate that the applicant is physically and emotionally able to operate a vending facility.

Despite regulations to do so, none of the medical evaluations documented that the applicants were physically able to operate facilities.

While five of the six referral packages we reviewed contained medical evaluations, none of the medical evaluations documented that the applicants were physically able to operate a vending facility. The evaluations primarily documented legal blindness and, for one applicant, TB status. State regulations require that applicants provide results of a TB test, and if positive, obtain a physician's statement that the disease is inactive and noninfectious. The one applicant tested positive for the disease in 1990. The panel did not request a doctor's statement until May 1997, when we brought the issue to the department's attention. This was one month after the applicant graduated from the initial training course.

Only one of the six referral packages contained a vocational evaluation that provided sufficient information about the applicant's potential to operate a vending facility. According to one member of the panel, a work history and a math test constitute a vocational evaluation. However, the work history may not reflect whether an applicant has the potential to operate a vending facility. In addition to the work history, the panel also considers an evaluation of the applicant prepared by the vendor of the facility where the applicant completes his or her one month on-the-job training.

In 1992, changes in federal law governing rehabilitation services in general required that the department primarily use existing information when identifying the rehabilitation needs of all clients and developing vocational goals and objectives. In addition, clients must be active participants in the process. According to the deputy director of field operations, the department only requests the medical and vocational evaluations referenced in the state regulations when available information is insufficient to identify and develop the client's choice of vocation. Further, the department emphasizes the client's choice unless compelling information indicates to do so would not be in the best interest of the client. The department believes that the state regulations specifically requiring medical and vocational evaluations that indicate an applicant is physically and emotionally qualified to operate a vending facility are no longer appropriate in light of the changes to federal law.

Even though federal law changed in 1992, the department has not proposed changes to state regulations.

Despite the changes to federal law in 1992, the department has not proposed revisions to state regulations to remove the provisions requiring these evaluations for program applicants. Further, the department has not complied with the state regulations. Before taking any action to change the regulations, however, the department should ensure that the requirements for vocational and medical evaluations are not necessary to determine an applicant's potential for success in the program.

The Department's Location Development Efforts Are Inadequate

The department does not make a concerted effort to establish new, more profitable vending locations. It is an important function of the program to establish new and improved vending locations to fulfill the intent of the Randolph-Sheppard Act, which is to encourage self-sufficiency and enlarge the economic opportunity of the blind. To become self-sufficient, licensed vendors must have the opportunity to operate locations that will provide an adequate income. Enlarged economic opportunity implies upward mobility, which is defined by the federal Rehabilitation Services Administration as training and opportunity for vendors to take on more complex vending operations with the potential for greater economic gain. Therefore, the department must have larger, more complex, and more profitable locations available for vendors to achieve upward mobility.

The need to develop new and more profitable vending locations is important not only for the department to serve existing vendors but to make the program attractive to potential clients. The department may be able to serve a greater portion of the blind community if it takes all feasible steps to establish new and more profitable vending locations.

State and federal laws require the department to establish vending facilities wherever feasible on state and federal property. These laws also encourage establishment of vending by blind persons on private, county, city, or other political subdivision property.

More Aggressive Location Development Efforts Are Needed

The department needs to be more aggressive in location development. To accomplish its mission, the department must seek out and develop profitable vending locations. In fiscal year 1995-96, 56 percent of vending locations netted under $2,000 per month; therefore, it appears that more profitable locations are needed.

Rather than pursuing new, more profitable locations, the department waits for potential sites to be referred to it.

The department receives referrals from federal and state authorities about potential new locations, but few referrals are developed into vending facilities. According to data reported by the department to the federal government, over the last 4 years, 29 referred locations were accepted, and 148 were rejected as not feasible. As of the end of fiscal year 1995-96, 38 potential locations were pending decision.

Instead of merely waiting for referrals, the department needs to pursue new kinds of places for its vending locations with a view toward present and future profitability. This is particularly important because the department has indicated that the decrease in employees in state, federal, and certain county office buildings is reducing the profitability of traditional locations. The department should seek out other types of public sector opportunities, including popular destinations for the public. For example, Nevada's Business Enterprise Program has three successful gift shops at Hoover Dam. The department should also pursue untapped opportunities for profitable vending locations in both private and other public entities. However, the department questions its overall capacity to pursue these opportunities given its limited resources.

The department explored possible Department of Defense sites only after threats of legal action.

An indication of the department's lack of initiative in location development is that the California Vendors Policy Committee (committee) recently decided it was necessary to explore its legal options with respect to the department's inaction in pursuing potential vending locations at Department of Defense facilities. According to the committee, it has been trying to get the department to look into these types of locations over the last two years because they have the potential to be very profitable. The department's chief deputy director stated that the department did not aggressively pursue these locations after its initial inquiry in 1995 because limited staff time was available due to pending litigation and ongoing workload. Further, the department believed that the Department of Defense locations posed significant and complex legal concerns which could create liability for the State. Finally, he acknowledged that the department had limited knowledge and experience in structuring contracts with food service companies and with the military contracting and procurement processes. Recently, as a result of the committee's plans to initiate legal action, the department decided to devote staff to explore the issues related to the Department of Defense locations rather than have staff time devoted to defending litigation. Nevertheless, the department should research and analyze potential vending location opportunities as they become known, rather than act only when faced with legal action.

Another factor contributing to the shortage of locations in California is that more locations have been closed than opened over the last several years. As shown by Table 1, over the period from fiscal year 1991-92 to fiscal year 1995-96, 91 locations were closed whereas only 64 were established, according to data reported by the department to the federal government.

The dwindling number of vending locations represents decreased opportunity for the vendors. Although it is true that the department has a responsibility to close down unprofitable locations, it is not offsetting the reduction in the number of locations by aggressively pursuing new ones.

Table 1

Locations Opened and Closed
Fiscal Year 1991-92 through 1995-96

	Fiscal Year 1991-92	Fiscal Year 1992-93	Fiscal Year 1993-94	Fiscal Year 1994-95	Fiscal Year 1995-96	Total
Opened	16	12	5	27	4	64
Closed	11	16	16	22	26	91
Net Increase/ (Decrease)	**5**	**(4)**	**(11)**	**5**	**(22)**	**(27)**

Combining lower-earning locations could help alleviate the shortage of profitable vending locations.

Furthermore, the department does not creatively develop solutions for combining several low-earning locations into one viable site. The department has the legal and regulatory authority to combine locations that are not viable to stand alone. The department has combined some locations in the past, but it could do more to develop creative ideas for combining new and/or existing smaller locations. Particularly with the downsizing of personnel in state and federal buildings, certain buildings cannot support a full-scale cafeteria or snack bar, and combinations of lower-earning locations could help alleviate the shortage of sites providing a sufficient income. Some of the locations that have been closed could have been combined with other smaller facilities to create a viable vending location with better income potential.

For example, the department did not attempt to take advantage of a potential opportunity to combine locations in the state capitol area in Sacramento. One state building had a Business Enterprise Program vending facility, but it closed due to unprofitability. The building management wished to have a coffee cart to provide coffee and food items such as pastries and sweet goods. Aware of blind vendors' priority, the building management contacted the department, but the department did not respond to several requests. The building management finally contracted directly with a private coffee cart operator. The department became aware of this soon after the contract was signed. The department discussed the idea of developing a "route" of coffee carts to be placed in this location plus five other recently-closed Business Enterprise Program facilities within a four-block area, yet it did not follow through with this idea, basing its decision on minimal analysis.

In other cases, an existing lower-earning location could be supplemented by a coffee cart, hot dog stand, or other small facility that cannot stand alone as a viable location. The

The department does not believe it has the authority to supplement existing locations; however, we disagree.

department stated that there are no regulations that allow it to supplement an existing, occupied vending location with a cart or satellite facility unless they are in the same building. Based on our review of the laws and regulations, we disagree. Furthermore, the department stated that it does not have a method of fairly assigning such satellites. However, the department has also stated that it will make exceptions to its procedures and assign satellite locations at certain county locations if the county insists and the department would otherwise risk losing the location. We believe that instead of managing this process by exception, which leads to the very unfairness it is trying to avoid, the department should formulate criteria and procedures for supplementing poor locations with satellites, and apply them consistently. The department should increase its efforts to develop creative solutions to its shortage of profitable vending locations.

The Department Has Not Demonstrated That It Has Established Vending Facilities in All Feasible Locations

The department does not always sufficiently document its analysis of the viability of a potential vending facility. Without such documentation, we were unable to determine whether the department performed adequate analysis to ensure that all potentially feasible locations were developed as vending locations. We tested ten referred locations that were not developed into vending facilities and found that five had some documentation but not enough to support a conclusion that they were not feasible, two were pending and require department follow-up, and only three analyses were adequately documented.

For example, one of the five rejected without adequate documentation was a potential location in a private hotel/restaurant. The private company also was looking into the potential for a future theme park, and there was the possibility it would welcome some involvement by the program, according to the records we reviewed. Because the department only had minimal information on the location, it requested more details. The department's records indicated it was waiting for a return telephone call as of March 1996. However, there is no record that the department made any further inquiries. The department subsequently reported this location as "not accepted due to unfeasibility of the location" on its fiscal year 1995-96 annual report to the federal government. We question how the department determined this location was not feasible when it

The department concluded a site was not acceptable when it possessed very little information about its potential.

had so little information about its potential, and its only documented follow-up action consisted of waiting for a return telephone call.

In another example, a utilities district contacted the department about the potential for a snack bar in its new building with approximately 600 employees. Even though blind vendors do not have legal priority in nonfederal/state property, state law requires the department to encourage the establishment of vending facilities on such property. Nevertheless, the department has not demonstrated that it took all necessary steps to pursue this opportunity. According to the department, the snack bar's feasibility was doubtful because of certain items the district was not willing to negotiate. However, in a letter to the department, the district stated that monthly rent and other features were negotiable. Further, the department's only proposal was a letter to the district listing conditions that would have to be met if the department was to even consider the potential snack bar. According to the department, the district did not respond to the letter. The department maintains that the proposed location was not feasible the way the district wanted it. However, there is limited analysis by the department to show how it reached this conclusion or that it attempted to negotiate a contract.

In addition, the department has not utilized another vehicle for identifying potential vending locations. State law requires the department to prepare a report based on a comprehensive analysis of state and federal property for reporting to the California Vendors Policy Committee (committee) and the Legislature. This report would identify which properties either have, or could accommodate, a vending facility, and which existing facilities are operated by licensed blind vendors. Despite requests by the committee, the department only prepared this report once, in 1992. The department believes it is not required to prepare the report because of a paperwork reduction act. However, we believe that the department is still required to prepare the analysis because the act applies to reports prepared for the Legislature or the governor, whereas the report in question is primarily prepared for the committee. Without a periodic analysis, the department cannot ensure it has considered developing facilities in all potential locations.

Moreover, the department does not appear to be doing all it can to pursue blind vendors' legal priority for operating vending facilities, even though blind persons have priority for operating vending facilities on state and federal property by law. The department stated that it has been proactive by adding a provision to the State Administrative Manual directing state agencies to contact the program for their food and beverage needs. It also stated that it receives information on potential vending locations from state and federal authorities, as well as reports from field staff when new construction comes to their attention. However, the department should take a more active approach to ensure that vendors' priority is exercised on state and federal property. For example, if it prepared the required report of potential locations as discussed above, instead of waiting to be contacted, it could determine whether food service operations were being run by nonprogram vendors.

We found that 53 percent of surveyed vendors believe the program needs more locations, better site development, and improved business opportunities.

Further, 62 (53 percent) of the vendors responding to the questionnaire expressed the opinion that the program needs more locations, better site development, and improved business opportunities. Some of these comments are listed below:

"...just not enough being done to open new vending facilities."

"Only a few sites are making a livable income. One-half or more of the vendors are receiving some type of aid."

"...[Make] sure all food services in federal, state, and county buildings are offered to blind vendors."

"Not much attention [is] given as to whether [the facility is] a good location."

"More effort should be spent on pursuing correctional facilities and universities."

In answer to whether there is upward mobility in the program, certain vendors answered:

"No, because they've lost so many key locations."

"Yes, and [it] would continue if the blind could stop what I perceive as the county not wanting the disabled."

"No, until the [department] realizes that it is time for it to work with and for the vendors...we will never have any good upward mobility."

The Department Has Taken Some Positive Steps in Location Development

Although the department has not pursued new location development as well as it should, we noted certain areas where it has made positive progress in developing new locations, including facilities at roadside rest stops and in the state Department of Corrections.

Adding roadside rest vending facilities and establishing sites at prisons will enhance the program.

The department presently has an interagency agreement with the California Department of Transportation (Caltrans) for the development of new vending facilities at roadside rest stops. Approximately 15 new vending facilities at roadside rest stops have been authorized by the department. Roadside rest stops are a positive development for the department because they can provide lucrative opportunities for vendors. Out of the seven roadside rest stops operated by program vendors as of December 31, 1996, one made more than $13,000 per month, four earned over $5,000 per month, and only one averaged below $2,000 per month during fiscal year 1995-96. Further, during our site visits, we observed that these locations appeared to be modern businesses that attracted many customers.

In addition, the department has recently established an interagency agreement with the state Department of Corrections that will allow the department to establish snack bars, cafeterias, or vending machine locations to serve visitors and employees at prison facilities. We believe this represents another positive step for the department because the Department of Corrections is expected to have a growing population of visitors and employees in the coming years.

However, despite these instances of positive progress, we believe that because of its insufficient location development overall, the department is not adequately fulfilling its purpose of enlarging the economic opportunity of the blind or assisting them to become self-supporting.

The Department Should Actively Explore Possibilities for Expanding Business Opportunities

The department does not adequately explore and implement innovative new business approaches to food service and related markets. In order to fulfill the Randolph-Sheppard Act's purpose of enlarging the economic opportunity of blind vendors, the department should strive to identify and implement new and lucrative opportunities.

Other states have tried new approaches including gift shops, convenience stores, and catering operations.

To ensure that its vendors can be competitive in business, the department should study the successes of private enterprise to get ideas for new opportunities for the program. Current trends in the food service industry lean away from cafeterias and toward espresso carts, food courts, hot dog carts, vending machines, and other fast food service. Cafeterias may still be appropriate in certain locations, but the program should actively explore new ideas for vending facilities. Other states are trying new approaches. One state finds that gift shops are very profitable and another has pilot convenience stores and catering operations. Although it has stated that it has been looking at new ideas, the department has generally been slow to investigate or develop them. We did note that the department has recently increased the number of locations with espresso service. However, when we asked the department for the status of its plans for new business ideas, it stated that the ideas were still in the discussion stage.

Some of the comments we received from vendors in this area were:

"We have antiquated cafeterias, dry stands. We are not utilizing patio style espresso carts, hot dog wagons, portable food service vehicles..."

"...better research for getting locations....Need to update the program itself—equipment is out of date."

"As times change and products change, some equipment needs to change also. This cafeteria was built 28 years ago and has never been remodeled..."

Another suggested, *"...cappuccino carts, soup and hot dog carts located in high traffic areas..."*

"...arrange to provide...copy machines and fax services for customers."

Because the department does not actively explore possibilities for expanding business, existing vending locations are not as profitable as they could be, and the department does not enhance economic opportunity for the blind.

The Department's Interim Location Process Needs To Be Modified

The department's policy for classifying and circulating locations is inequitable because it has not developed a fair process for handling locations that average less than $2,000 in net income per month.

The department classifies locations into two categories: primary and interim. Primary locations are those that have the potential to produce more than $2,000 per month in net income and are awarded to vendors on a permanent basis. To circulate a primary location, the department has established procedures that resemble a normal competitive bidding process. Specifically, it mails out an announcement to all the vendors when a primary location becomes available. Interested vendors apply for the location and participate in an interview process. The interview panel scores each applicant and awards the primary location to the vendor with the highest score.

Despite competitively awarding permanent sites, the department has not developed a fair process for awarding interim locations.

Despite this competitive process for permanent sites, the department has not developed a fair process to award the interim locations. The department classifies any location as an interim location regardless of income potential if it does not have enough time to send out the location announcement, if no vendor applies for the location after it has been circulated as a primary location, or as deemed necessary by the program administrator. To be eligible to operate an interim location, vendors must maintain minimum operating standards at their vending facilities and may not have any outstanding, delinquent amounts due to the department. Vendors who meet these criteria are placed on an interim vendor list. Unlike the procedures used to award a primary location, when an interim location becomes available, the department reviews its interim vendor list, and, at its own discretion, selects a vendor to operate the location. As a result, the department has eliminated the competitive bidding process that would provide all vendors the opportunity to apply.

Further, the department's policy is to allow a vendor assigned to the interim location to continue operations as long as the location cannot produce $2,000 per month in net income. Other than terminating the location or vendor for good cause, the department's current policy only allows it to remove vendors from these locations at the end of a six-month interim agreement if there is sufficient reason to reclassify the interim location as a primary location. This policy is inequitable because it permits vendors to operate what is effectively a permanent location without participating in the competitive process for circulating and awarding permanent locations.

For example, as of July 1997, out of approximately 210 locations, there were 58 interim locations. Of these, 37 (64 percent) were operated for more than one year by vendors who were awarded the locations outside of the competitive application process. Of the 37, 18 (49 percent) have been operated by the same vendors for more than two years. The inequity is even greater considering that some vendors operate more than one interim location. Specifically, we found that ten vendors were operating at least two interim locations each, and in three cases, vendors were operating three interim locations.

In addition, the department has not been circulating all interim locations which produce more than $2,000 per month in net income. As discussed earlier, locations that have the potential to produce more than $2,000 per month should be circulated as primary locations. Specifically, we noted six instances where the location averaged more than $2,000 per month in the first ten months of fiscal year 1996-97. Three of these six locations also averaged more than $2,000 per month in fiscal year 1995-96. All six of the locations have been interim for more than one year. By not circulating these six locations, the department has withheld profitable locations from competitive bids of all interested vendors.

Contrary to the department's policy, we believe there are no restrictions on the number of primary locations a vendor may operate.

The department also allows vendors operating primary locations to operate interim locations. If the department circulated the interim location to all vendors as a primary location, the interim vendor who is currently operating a primary location would be ineligible to operate that location in addition to his or her current primary location because the department's current policy is to not approve vendors to operate multiple primary locations. However, based on our review of laws and regulations, we believe there are no restrictions on the number of primary locations a vendor may operate.

If the department were to circulate all locations among all vendors, they would have a fair and equal opportunity to operate the locations which they believe would meet their needs.

Recommendations

To ensure that it is adequately promoting the program, the department should take the following actions:

- Consistently inform all RCBs and counselors about the program to ensure that all blind clients of the department are made aware of it; and

- Initiate mailings to blind individuals and community organizations to ensure that blind individuals who are not currently clients of the department are made aware of the program.

To ensure that all applicants meet criteria for the program, the department should take the following actions:

- Comply with existing state regulations, or if appropriate, propose revisions to the state regulations to remove the requirements that medical and vocational evaluations document an applicant's physical and emotional qualifications to operate a vending facility; and

- Require medical evaluations that provide evidence of the applicant's TB status.

To fulfill its mission to provide blind persons with enlarged economic opportunities and assist the efforts of the blind to be self-supporting, the department should do the following:

- Aggressively identify and establish profitable vending locations on both public and private property, combine locations when beneficial, and document the analysis performed to determine a location's potential;

- Formulate criteria and procedures for supplementing less lucrative locations and apply them consistently; and

- Establish a process to identify and pursue priority for blind vendors when a state or federal facility has a vending facility that is not operated by a licensed blind vendor.

To ensure that it is taking adequate steps to expand business opportunities, the department should establish procedures to systematically study the successes of private enterprise and analyze potential lucrative business opportunities. In addition, it should consider innovative ways to implement new business opportunities in the program.

To ensure that its policy for classifying and circulating locations to vendors is equitable, the department should establish procedures to circulate all vending locations to eligible vendors.

Chapter 2

The Department Is Not Fulfilling Its Responsibilities in Providing Vendor Advice and Assistance

Chapter Summary

The department needs to more effectively fulfill its responsibilities to both the vendors and the Business Enterprise Consultants (BECs) who provide the vendors with advice and assistance on operating vending facilities. For example, the department does not adequately provide training for all vendors to improve operations at their current locations or enhance their skills to operate more complex facilities. Moreover, the department does not always emphasize consulting services, which are designed to identify and resolve issues that negatively affect vendors' profitability. In addition, the department reduces the effectiveness of the consulting services provided to vendors because it does not provide sufficient training or guidance to the BECs and does not enforce the procedures which require BECs to conduct specific reviews of vendor performance. Further, it has not adopted procedures that compel vendors to adhere to the terms of their contracts with the department.

By providing adequate training to all vendors, refocusing the BECs' role on consulting services, and providing sufficient training and guidance to the BECs, the department can ensure that it is empowering vendors to successfully operate vending facilities.

Initial Training Course Appears Adequate To Prepare Applicants for the Program

The background of the trainer, the curriculum, and the continuous monitoring of trainees appear adequate to prepare a qualified trainee to operate a vending facility. In our survey of the vendors currently licensed in the program, 85 percent of those responding indicated the initial training was relevant and helpful.

After receiving approval by the Applicant Review Panel, the applicants begin the initial training course offered by the program. The six-month course, facilitated by a program trainer with an extensive background in the food service industry, is a combination of classroom instruction and on-the-job experience. Over the last four years, the department has incorporated material from the National Restaurant Association's (NRA) management program. The NRA material has now become the primary curriculum and trainees obtain NRA certification for these subjects.

The department continuously evaluates the trainees' progress during the course. The program trainer provides guidance to those trainees who experience difficulties. Trainees who successfully complete the course and become licensed are eligible to bid for any type of facility and can also operate more than one type of facility during their years in the program.

The Department Offers Limited Opportunities for Ongoing Training

The department uses its initial training program to meet both in-service and upward mobility responsibilities.

Although federal and state law require that the department offer ongoing training to the vendors to improve operations and foster upward mobility, the training offered is limited.

The department is required to provide in-service training to improve vendors' current operations, and upward mobility training to increase vendors' skill levels to become qualified to operate more complex vending facilities. It provides in-service and upward mobility training in a limited manner. For example, the department generally uses the NRA curriculum designed for the initial training program to meet federal and state requirements for both in-service and upward mobility training. The department permits existing vendors to attend any initial training class on a space-available basis. According to the program's advanced training coordinator, in-service training may allow for upward mobility and upward mobility training may include in-service training depending on each vendor's unique situation.

The use of the initial training curriculum as both in-service and upward mobility training appears reasonable for vendors who have not obtained certification from the NRA. However, for recently licensed vendors who already received initial training or obtained NRA certification, the department does not provide useful training that would hone skills, provide new ideas, teach innovative techniques, or improve business skills.

Additionally, the department offers few other ongoing training opportunities. For example, during fiscal year 1995-96, the department offered three classes in vending machine repair that were limited to seven vendors per class. In addition, the department provided textbooks, audio tapes, and individual consultations to other vendors as in-service and upward mobility training.

We asked the vendors what type of ongoing training classes they received. Fifty percent of the vendors either did not respond to the question or stated that the question was not applicable to them, which would be the expected responses if the vendors were not receiving ongoing training. Certain other vendors responding to our survey expressed dissatisfaction with the ongoing training. For example, vendors indicated that classes addressing new trends in the food service industry, business tax preparation, and new business tax laws would be useful. In addition, one vendor indicated that she receives ongoing training from other sources because she does not believe the training offered by the department would be beneficial to her, while another stated that he would attend classes if he did not have to travel to Sacramento and if classes were held on the weekends.

The Department Needs To Emphasize Consulting Services

The BECs should evaluate areas that may limit vendor success and require consulting service.

The primary role of the Business Enterprise Consultant (BEC) should be to ensure the success of the vendors by advising them on operating vending facilities and suggesting how to improve profitability. Although procedures exist to ensure that the BECs provide adequate consulting services to vendors, the department does not always emphasize this aspect of the BECs' job nor do the BECs always effectively use the management tools provided. Consequently, the consulting services provided by the BECs have limited value to the vendors.

The BECs evaluate vendors and vendor facilities to identify areas that may be limiting success and identify specific issues that require consulting services. These evaluations include a review of the monthly profit and loss statements (P&Ls) prepared and submitted by the vendors, as well as quarterly reviews of location (location reviews) and an annual vendor appraisal. The evaluations reveal aspects of vendors' operations that need changes or improvement, such as sanitation and safety, purchasing, merchandise display, or financial management.

We found BEC consulting services, other than responding to vendor questions, to be primarily limited to a review of P&Ls, occasional vendor appraisals, and infrequent location reviews. Further, BECs spend a significant amount of time with equipment purchasing and repair, which reduces the time available for these consulting services.

Review of Profit and Loss Statements

The vendors' P&Ls are monthly reports that detail the sales, expenses, and income of a vendor's location. By reviewing P&L data and comparing expenses with guidelines established by the department, the BEC is able to monitor the operation of a vendor's location and offer advice in areas that may increase the vendor's profitability.

BECs' review of P&Ls falls short of promoting and encouraging vendor success.

Reviewing the P&Ls and comparing expenses with established guidelines are reasonable methods to monitor the profitability of a vendor's location. However, the overall process falls short of promoting and encouraging vendor success. Specifically, the effectiveness of advice based upon P&L data is questionable because the BECs do not receive the P&Ls quickly enough to promptly respond to problems, such as unreasonable food costs or excessive labor costs. Due to the department's procedures, the BECs do not receive the P&Ls until two or three months after the reporting month. Problems may already be well-advanced before BECs see the P&L. For example, a vendor's sales may have been down significantly for two or three months, but by the time the BEC knows of this, the vendor may already be in debt.

In addition, the department does not ensure that BECs perform adequate follow-up with vendors who do not submit P&Ls as required by state regulations. As discussed in Chapter 3, 15 percent of the vendors had at least one missing P&L as of December 31, 1996, and 49 percent of these were over six months old. Missing P&Ls make it difficult for the BECs to offer consistent or complete advice on a vendor's operations.

Further, the department is not ensuring the accuracy of the data on the P&Ls. The department must ensure that vendors are maintaining accurate records so that the BECs can verify and rely on the P&L data. Accurate P&Ls enable the BECs to correctly identify problems that may exist and assist them in offering relevant advice to the vendors. However, the department does not always enforce state regulations requiring vendors to maintain adequate records. Two BECs we interviewed stated that they do not ensure that vendors maintain adequate records to support the data on the P&Ls. Further, one other BEC indicated that many vendors keep their records at home, making it difficult to verify the P&Ls. Another BEC suggested that the department require vendors to submit cash register tapes at the end of each month to ensure the accuracy of the P&Ls. Additionally, as discussed in Chapter 3, the department's internal audit unit found that all four vendors audited in the last two years were unable to provide supporting documentation for their cost of goods sold.

The department has not required all BECs to use consistent, reliable guidelines for reviewing P&Ls.

Also, in reviewing the P&Ls, not all BECs use the expense guidelines established by the department. Four of the five BECs we interviewed used only information presented in the Keating report as guidelines or used the Keating report in combination with the department guidelines. The Keating report, issued in 1993, reviewed the department's guidelines because the vendors expressed concern that the guidelines were outdated. It examined statewide expenditure patterns for a three-month period and found the net income rates based on these patterns to be generally comparable to the department's guidelines. However, the analysis also revealed variations among geographical areas of the State that the department's statewide guidelines did not address. Although not adopted by the department, some BECs use the expenditure patterns from the Keating report for their geographical areas as guidelines in their reviews of P&Ls. In certain instances, the Keating report's expenditure patterns varied substantially from the department's guidelines. For example, in the Los Angeles area, the Keating report's expenditure patterns for cost of goods sold at vending machine facilities is 33 percent of sales, compared with the department's guidelines of 65 percent of sales, a difference of 32 percentage points.

While comparing actual expenses with guidelines is a reasonable method to uncover potential problem areas, neither the Keating report's expenditure patterns nor the department's guidelines may be appropriate for this task. The department was unable to provide us with documentation to support how its guidelines were developed or whether the guidelines have been updated to reflect current industry conditions. By not requiring all BECs to use consistent, reliable guidelines, the department cannot ensure that the vendors are receiving relevant and reliable advice from the BECs.

Vendor Appraisals and Reviews of Locations

The BECs do not always complete appraisals and location reviews consistently or accurately. As a result, they are not maximizing opportunities to offer consulting services to vendors. Moreover, the BECs cannot ensure that they promptly address the aspects of vendors' performance that negatively affect their profitability.

In addition to reviewing P&Ls, the BECs are responsible for appraising vendors annually and reviewing locations quarterly. The appraisals focus on a vendor's performance while the location reviews primarily focus on qualities of the vending facility. The appraisals evaluate a vendor's performance on a scale of excellent to needs improvement in five areas: public relations, merchandising, supervision of employees, financial responsibility, and sanitation and safety. In addition, the department uses information on the appraisals in its selection process when awarding facilities to vendors.

BECs are not conducting required annual appraisals or quarterly location reviews that ensure facilities are operated at an optimum level.

The purpose of location reviews is to ensure that vendors are operating facilities at an optimum level. The BECs evaluate the following specific elements: general appearance, merchandising, customer service, personal hygiene, equipment care and maintenance, and safety. A critical element of the location reviews is the BECs' evaluation of whether the vendors are maximizing the facility's full financial potential. Both the appraisals and location reviews also provide the BECs with opportunities to recommend changes to improve profitability.

We reviewed a sample of 15 vendor files and found that the BECs did not complete an appraisal within the last year for 10 of the vendors. For 7 of the 10 vendors, the BECs have not completed an appraisal in over five years. The most recent appraisal for one vendor was 1980. In addition, we found that as of May 1997, none of the 15 vendors in our sample have had a quarterly location review since December 1996. One vendor's most recent location review was dated January 1985. Four of the vendor files did not contain any reviews.

We also noted that the BECs do not always complete vendor appraisals accurately. For example, of the five vendors who have had recent appraisals, two were delinquent in loan repayments or set-aside fees for a combined amount of nearly $2,300. However, the BECs gave excellent ratings to both vendors for their ability to meet financial obligations in a timely manner. In another instance, the BEC rated a vendor's sanitation and safety efforts as very good. However, in a letter to the building management dated one day after the appraisal, the BEC described actions that would be, or had been, taken to address sanitation issues at the facility.

According to certain BECs we interviewed, appraisals are primarily completed when a vendor is applying for a different facility. According to the assistant deputy director who oversees the program, the department has not strictly enforced the procedures relating to appraisals and location reviews because of more urgent program priorities, limited staff resources, and daily workload demands. He further stated that BECs have many tasks to perform but must allocate sufficient time to the equipment services critical to the program. However, we believe that consulting services are also critical to the program.

While the vendors have a responsibility to make their facilities successful, the department also has a responsibility to provide adequate consulting services to promote and encourage vendor success. By not requiring that appraisals and location reviews be completed consistently or accurately, the department cannot ensure that it is meeting its primary mission to ensure the success of the vendors.

Thirty-nine percent of vendors surveyed stated that BEC consulting services did not meet their needs.

In response to our vendor questionnaire, 39 percent stated that BEC consulting services did not meet their needs. Vendors commented that BECs need more training, more time to provide business consulting services, and more time in the field. Further, 33 of the 117 vendors (28 percent) responding to the questionnaire indicated that they received less than four site visits from their BECs last year.

The Department's Equipment Policy Limits the Time Available for Consulting Services

BECs spend a significant amount of time with equipment services. Specifically, the BECs purchase all of the vendors' equipment, coordinate equipment maintenance and repair with service companies, arrange for equipment moving and disposal, and perform physical inventories of each vending facility.

While each of the BECs performs similar equipment services, the time involved in providing these services varies. According to the duty statement prepared by the department, the BECs should spend approximately 30 percent of their time on equipment services. However, one BEC indicated he spends approximately 60 percent of his time on equipment-related tasks. Another BEC indicated that equipment services comprise

50 percent of her time. Consequently, vendors throughout the State may not receive comparable services because the amount of time spent on consulting services varies by BEC. While we believe that proper, well-maintained equipment is a component of operating a successful facility, the BECs' ability to promptly identify and address issues affecting a vendor's profitability results primarily from consulting services, not equipment services. Therefore, the department's policy of requiring BECs to be involved in all aspects of providing and maintaining equipment may be an inefficient use of their time when the main role of the BEC is to promote and encourage vendor success. Both the Keating and University of California, Davis management reports also identified the need to reduce the amount of time BECs spend on equipment services.

Two previous management reports also identified the need to reduce the amount of time BECs spend on equipment services.

Concerns over the department's equipment policy voiced by the vendors responding to our survey include the following:

"[The department's] procurement procedures hamper [my BEC's] ability to serve me."

"Basically, [the BECs are] in the procurement service; they don't provide any business advice."

"The equipment ordering system should be overhauled."

"More efficient and faster procurement of equipment would improve the program."

"[The department needs to act] more quickly in responding to repairs and equipment needs."

The Department Needs To Provide Sufficient Guidance to the BECs

In addition, the department does not provide the guidance to the BECs necessary for them to be effective. Moreover, the department has not established clear policies for the BECs to follow when counseling vendors who do not comply with their department contracts. As a result, the department is not doing all that it should to ensure that the BECs fulfill their obligation to the vendors and ensure the continued existence of the program. Further, lack of guidance to the BECs may result in inconsistent treatment of vendors.

While management tools designed to assist vendors are available, namely the P&Ls, appraisals, and reviews, the department has not adopted procedures that allow the BECs to use these tools effectively. For example, the department has not provided sufficient guidance to the BECs concerning the use of expense guidelines, as discussed previously, or the completion of the reviews. In the absence of guidance regarding the completion of the reviews, we found that three of the BECs we interviewed do not use the same criteria to determine whether a facility is maximizing its financial potential. In addition, BECs interviewed stated that the department does not have a formal training program for BECs to teach them how to effectively use the management tools and does not schedule routine meetings for the BECs to address common issues and concerns or discuss department policies. The department offers training to the BECs that includes time management, communication skills, and computer classes. However, the training does not include topics specific to reviewing P&Ls or completing appraisals and reviews. Further, the training the BECs receive is infrequent, with some BECs receiving little or no training within the past two years.

Management tools exist; however, the department has not trained BECs on their effective use.

The BECs also expressed frustration with the lack of policies that address a vendor's compliance with regulations or the BECs' suggestions for improving profitability based on appraisals and reviews. As discussed earlier, the department does not always enforce regulations that require vendors to submit P&Ls or maintain adequate records, even though the vendors agree to follow these and other regulations identified in their contracts. Further, the department does not always require vendors to comply with expense guidelines or adopt the BECs' suggestions. Because it does not hold vendors accountable for complying with the terms of the contract and because it does not require vendors to make use of BECs' suggestions, the consulting services offered by the BECs can be of little use.

The department needs to establish clear and uniform policies for the BECs to follow when counseling vendors who do not comply with contract terms. Also, the department should modify vendor contracts to include ranges of acceptable performance. In addition, the department must ensure that all vendors are held accountable for complying with the contracts. Finally, should a vendor fail to respond to counseling, the department's remedy would be to suspend or terminate the contract as prescribed by state regulations.

Although we believe BECs need to refocus their efforts and need more guidance from the department, certain vendors responding to our questionnaire indicated that program services meet their needs. Specific comments include the following:

"Even with all the problems in the program, I believe I have been given a great opportunity to realize my lifelong dream of becoming an entrepreneur."

"[The program] provides a great opportunity to succeed in business."

"During the 15 years that I have been in [the program], I have been able to make a living."

Nonetheless, other vendors expressed dissatisfaction with the current role of the BECs and the program in general. Their responses included the following:

"[The BECs need] more free time to advise and check on operations in the field. There is too much office work required."

"[BECs] should be organized so that they could offer more support and assistance."

"This is a good program for the blind population. It should be strong and healthy, not sick and dying."

"All the majority of vendors want to do is make a living, but we lack the support services we should be getting."

"[The program needs] better training of BECs."

"[The department] needs a plan for the direction and management of [the program], uniformity and consistency in policies, and to enforce the laws and regulations when vendors don't [comply]."

"[The department should] discipline vendors who take advantage of the program and do not pay proper fees."

Recommendations

To improve its ongoing training program, the department should take the following actions:

- Ensure that the curriculum provides opportunities for all vendors to improve current operations or improve existing skill level to advance to more complex vending facilities; and

- Consult with vendors to develop ongoing training classes that meet their needs.

To ensure that the program meets its responsibilities to promote and encourage vendor success, the department should do the following:

- Enforce the state regulations that require vendors to submit P&Ls and maintain adequate records to assist BECs in performing P&L reviews;

- Develop procedures to ensure that the BECs consistently and accurately complete vendor appraisals and location reviews;

- Re-evaluate the use of BECs to provide equipment services, with the goal of optimizing the time available for adequate consulting services;

- Provide guidance to the BECs by developing a formal training program and scheduling routine meetings to discuss policies and procedures that will ensure consistency in the services provided to vendors;

- Establish clear policies for the BECs to follow when counseling vendors who are not complying with terms of their contracts;

- Modify vendor contracts to include ranges of acceptable performance, and uniformly enforce the terms of the contracts; and

- Suspend or terminate the licenses of those vendors who fail to respond to the BECs' counseling and continue to disregard contract terms.

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Chapter 3

The Department's Administration of Program Finances Needs Improvement

Chapter Summary

The Department of Rehabilitation's (department) inadequate administration of program finances impairs the program's growth and continued viability. For example, the department does not ensure that vendors promptly submit required monthly financial reports, fees, or loan repayments. In addition, the department is inappropriately using vendor set-aside fees to provide loans to vendors. Moreover, the department has not demonstrated that it administers set-aside fees in a manner equitable to all vendors. Further, while the department has made some improvement in ensuring it receives all vending machine commissions available to the program, more improvement is needed, and the department must ensure that it uses vending machine commissions for the benefit of all vendors. Finally, the department needs to improve its controls over program assets. As a result of current practices, the growth and maintenance of the program for the benefit of all vendors has been restricted.

Background

In 1995, we performed a financial audit of the program and found the department did not have a system to ensure it received all monthly profit and loss statements (P&Ls) and did not adequately pursue underpayments of vendor fees or loan repayments. The department responded that it was setting up a centralized system to track P&Ls, vendor fees, and loan repayments, and when vendors failed to submit timely reports, action would be taken as set forth in state regulations.

The department assigned a program analyst to create a database to track P&Ls, fees, and loan payments in September 1995; nevertheless, its efforts to follow up on missing P&Ls were not effective over the ensuing months. Based on our review of the department's records, it appears that in November 1996, the department refocused efforts to follow up on missing P&Ls.

Although the department has established a centralized tracking system, it is incomplete, inefficient, and contains errors. Additionally, the department has not been effective in following up on delinquent P&L reports, vendor fees, and loan repayments.

The Department Needs To Improve Its Management of Missing Profit and Loss Reports

The department does not always adequately pursue delinquent P&L reports. The department's failure to pursue delinquent P&L reports makes it difficult for Business Enterprise Consultants (BECs) to address problems. In addition, the department's process for forwarding P&L reports to the BECs is too slow to allow them to promptly address problems.

The department's failure to pursue delinquent P&Ls makes it difficult for BECs to identify and address problems.

State regulations require each vendor to submit a monthly P&L for each vending location by the 25th day of the following month. The P&L is a report of operations as well as the basis of calculating fees such as set-aside fees, workers' compensation, liability insurance, and retirement. The vendors remit these fees each month with the P&L report. The department also uses the P&L as a source for some of the information required for federal reporting, such as gross sales, operating profit, and net income.

The database established as the program's centralized tracking system for P&Ls is incomplete because it only includes records back to September 1995. Additionally, we noted missing information for certain vendors from September 1995 on. The department has not determined whether P&Ls before September 1995 will be added to the database and does not know how many P&Ls from that period are missing. If it does not add the missing data from earlier periods to its database, collection of any missing P&Ls or the accompanying set-aside fees for the periods prior to September 1995 is unlikely.

Furthermore, the summaries of missing P&Ls compiled using the database contain errors. Errors in the summaries could result either in the BECs not pursuing missing P&Ls or in wasting time to collect P&Ls already submitted. This is a problem for the BECs because they are required to ensure that vendors file the required reports. Out of 50 vendors tested, 6 errors were identified. For 3 of the 6, the summary indicated P&Ls were received when they were not. For another 2, the summary indicated P&Ls were not received when they actually were. The summary indicated the wrong year for another.

The department's procedures for identifying missing P&Ls are inefficient because the accounting section and the program section input P&L information into two separate systems. The accounting section's system is described in detail later in this chapter. The program section maintains a separate database to track missing P&Ls because it cannot rely on the accounting system to produce an accurate report of missing P&Ls.

To make matters worse, the process used to forward the P&L information to the BECs is slow. For example, the information sent to the BECs concerning missing December 1996 P&Ls was dated February 25, 1997, a full month after the P&Ls were due. If the BECs do not receive information on missing P&Ls promptly, they are unable to react quickly to a problem and form a corrective action plan before the problem becomes more serious.

Of 131 missing P&Ls, 64 percent were over 180 days late.

Further, the department has not effectively followed up on missing P&Ls once they are identified. It allows some vendors to become chronically behind, with multiple delinquencies. Our analysis as of December 31, 1996 revealed that of approximately 220 current and former vendors, 34 (15 percent) had a total of 131 missing P&Ls. Of the 131, 64 (49 percent) were over 180 days late. Over the 16-month period for which records are available, 7 vendors had not submitted between 6 and 12 P&Ls each, and the remaining 27 vendors had not submitted between 1 and 5 P&Ls. Based on our review of missing P&Ls, we determined that the department was not always prompt in contacting vendors and obtaining the P&Ls.

Finally, the department does not estimate fees and penalties for missing P&Ls as required by state regulations because it believes that doing so would require a significant amount of staff time. It only records fees and penalties when and if it actually receives the delinquent P&L. Because the fees and penalties are not estimated and invoiced, the amount that should be collected and deposited in the Vending Facilities Trust Fund (trust fund) and used for expansion and improvement of the program is unknown.

The department's inability to ensure that all vendors submit P&Ls as required has several consequences. Vendors who do not file their P&Ls are subsidized at the expense of other vendors who do file and pay their fees. Delinquent vendors continue to receive services such as maintenance and replacement of equipment paid for by set-aside fees even though they are not submitting their share of these fees. Failure to collect set-aside fees also limits the amount of program funds eligible for matching federal funding.

Because the department's system to monitor the receipt of P&Ls is lacking, BECs are unable to follow up with vendors promptly. When BECs do not follow up with vendors, problems with delinquencies are allowed to go unresolved. Additionally, the accounting records do not reflect the amounts that should be in the trust fund available for the growth and maintenance of the program because the department does not record estimated fees or penalties for missing P&Ls. Finally, the absence of P&Ls makes the State unable to provide accurate data in its required reports to the federal government.

The Department's Monitoring of Accounts Receivable Needs Improvement

Ninety percent of the department's accounts receivable were over 90 days past due.

The department does not ensure that it collects all the fees due from vendors. For example, the department's accounts receivable, which record unpaid vendor fees, reflect that approximately 90 percent of the accounts were over 90 days past due as of December 31, 1996. Also, the department does not promptly identify and counsel vendors who are falling behind in their payments. As a result, vendor debts can grow to unmanageable amounts. For example, in the last four years, two vendors have filed for bankruptcy protection while owing the department more than $24,000 and $32,000, respectively.

Accounts receivable related to the program originate from several different sources. For example, the department's accounting section inputs the P&L information and payment data into its financial system. Based on this data, the financial system calculates the amounts of set-aside fees and other amounts due to the department. The system produces an "adjustment sheet" if the fees a vendor remits with the P&L do not agree with its calculations. The adjustment sheets are recorded as contingent accounts receivable in the trust fund and copies are forwarded to the BECs, who notify the vendors. According to the department's procedures, the accounting section should send a series of three reminder notices to the vendor and if the contingent receivable is not paid or resolved within approximately 180 days, it should prepare an invoice and record a formal accounts receivable.

The Department Does Not Collect All Fees Due From Vendors

The department does not adequately ensure that vendors pay their fees as required by state regulations. Also, it does not adequately follow up on accounts receivable in accordance with the regulations, the State Administrative Manual, and its own procedures. In our review of the accounts receivable records as of December 31, 1996, we found that 94 percent of contingent accounts receivable ($129,000 out of $137,000) were over 90 days old, and 65 percent of those were from 1995 or earlier. Similarly, 86 percent of invoiced accounts receivable ($114,000 out of $133,000) were over 90 days old, while $83,000 has either been submitted to the Franchise Tax Board or the Board of Control as uncollectible, or is uncollectible due to bankruptcies.

$83,000, or about 62 percent of the invoiced accounts receivable, are uncollectible.

State regulations require the department to make every effort to pursue collection and state that failure to pay set-aside fees is grounds for termination or suspension of a vendor's license. The State Administrative Manual lists the steps the department should take in collecting accounts receivable. First, the accounting section is required to send a sequence of increasingly strong collection letters 30 days apart. However, the notices sent by the accounting section do not become stronger in tone, and are sent quarterly at most, and sometimes much less frequently. The next step is to turn the receivable over to the Franchise Tax Board. If this attempt to collect is unsuccessful, the department requests approval from the Board of Control to write off the debt. A receivable is several years old by the time it reaches this stage.

In addition, the department does not adequately follow up on contingent accounts receivable. In practice, the department does not reclassify and invoice these receivables until requested by the program section. A contingent receivable may remain on the books for a significant length of time with no further reminder notices sent.

Recently, the program has started to follow up on delinquent fees and P&Ls, as described earlier in this chapter. A program analyst, who maintains the centralized database, sends P&Ls, adjustment sheet copies, and accounts receivable ledgers to the appropriate supervising BEC for follow-up. Because this is a recent change, we could not assess whether there has been any significant improvement in collecting delinquent payments. Nevertheless, many long-delinquent vendor accounts still exist.

The Department Does Not Promptly Identify a Need for Corrective Action

The department does not promptly identify and implement corrective action plans with vendors who are falling behind in their payments. The program is required by its procedures manual to monitor and review fee payments. It is also required to pursue and document discussions with the vendor regarding past due payments, and follow up with letters to the vendor requiring compliance. If the vendor fails to make prompt payments, the program is to develop a written repayment plan. If the vendor does not make payments as agreed, after reminders from the program, the program is to take action to suspend the vendor's license. We examined five files for vendors with delinquent accounts and found that the department's follow-up was either late or ineffective in all five cases. The following examples illustrate the problems we found:

Due to late or ineffective follow-up, the department was unable to collect $56,000 in receivables from two vendors before they filed bankruptcy.

- Two of the vendors filed for bankruptcy after long-standing problems with delinquencies, and both have left the program. The department wrote off receivables of more than $24,000 for one vendor, and plans to write off $32,000 for the other vendor after the bankruptcy is finalized. These two cases are discussed in more detail below.

- Another vendor owed $2,000 for underpaying fees. The department's internal audit section identified this amount in November 1995, but it took until February 1997 to establish a one-year payment plan for him.

- One vendor owed delinquent amounts totaling approximately $4,500, some of which dated back to 1992. In addition, the vendor did not file ten P&Ls during the period October 1995 through August 1996. Thus, because the department has not estimated the amount of fees related to the missing P&Ls, the vendor could have owed significantly more than $4,500. The department also did not take action on the vendor's failure to submit P&Ls and payments until September 1996, and when it did, its efforts were deficient. For example, one notice requested only missing P&Ls and related payments; another only requested payment of $200 in delinquent invoices when the vendor also owed $4,300 in underpayments on previous P&Ls. After the department began its renewed tracking efforts, it put together a complete record of the vendor's delinquencies and missing P&Ls for the first time. The department later developed a plan for the vendor to pay

$50 per month, giving the vendor more than seven years to pay the entire $4,500. The vendor also still owes an unknown amount for delinquent P&Ls that have not been submitted.

- One vendor disagreed with the amounts recorded as accounts receivable. Certain of these amounts dated back to November 1995; however, the department did not begin to follow up until November 1996. The total receivable from this vendor was $1,400. Some of the delinquent amounts were over a year old before they were resolved in March 1997.

Severe consequences can occur when the department does not promptly take remedial action or allows unpaid fees to grow.

The circumstances that led to the two vendors filing for bankruptcy after long-standing problems with delinquencies illustrate the severe consequences that can occur when the department does not promptly implement corrective action. One of the vendors started to get behind in paying fees to the department in fiscal year 1992-93. The unpaid fees built up until the vendor owed the department a total of $32,000. The causes of the vendor's problems appear to have included decreasing building population and competition from another blind vendor. The department made limited efforts to obtain payment from the vendor. However, it did not consistently follow up and took no specific action to correct the problems, despite the vendor's requests for assistance.

For example, the department made rulings to the detriment of this vendor when in similar situations with other vendors, it made different rulings. Specifically, the department ruled that this vendor had to share certain revenues with another blind vendor in the same building, whereas in another building with two vendors, the department did not require such revenue sharing. Further, when the department finally acted on this vendor's debt, it decided that the vendor had to pay the entire amount back within two years, when in another similar situation (mentioned earlier), the department agreed to a payment plan over seven years. The two-year payment plan worked out to payments of approximately $1,300 per month even though the vendor was only making an average net income of $620 per month. The vendor stated that his location did not generate enough income to make the payments and resigned from the location.

This vendor may not have been doing everything possible to maximize the location's potential, but the department did not attempt to help the vendor. Moreover, the department appears to have made rulings that would tend to encourage the vendor to leave the program, such as the two-year repayment plan and the decision on the dispute with the other vendor. This vendor ended up filing for bankruptcy, and the department will have to write off his entire debt.

In another case, a vendor owed delinquent amounts for periods dating back to 1991 and was chronically delinquent in filing P&Ls. Again, the department failed to take action to effectively help and counsel the vendor. The vendor filed bankruptcy in 1993, creating a bad debt of more than $24,000 that the department had to write off. The vendor continued operating his vending location, and for the second time, the department allowed him to operate without paying his fees. The vendor left the program in 1996 owing approximately $7,000 more in fees. In this instance, however, the department was fortunate by being able to recover the $7,000 by applying an unexpected distribution from bankruptcy court, as well as selling the vendor's remaining inventory, when normally it would have written off this amount.

The department should analyze the causes of vendor delinquencies and quickly formulate corrective action plans.

As described above, some vendors owe the department substantial amounts of money, to the point that they are experiencing severe financial problems. The department should analyze the causes of the delinquencies and quickly formulate corrective action plans. The vendor may be unclear on how to organize his or her bookkeeping, unable to pay due to circumstances beyond his or her control (a decrease in building population, for example), or unable or unwilling to optimize his or her business, even though the vending location could be profitable.

If the vending location is the problem, the program should take steps to improve it, downgrade it to a lower-overhead facility, or shut it down and let the vendor apply for a new location. If the vendor simply is not making the required effort to make the business a success and to fulfill his or her financial obligations to the program and to others, e.g., promptly remitting amounts due to taxing authorities, the program should, after due effort to correct the situation, suspend or terminate the vendor's license, in accordance with the Randolph-Sheppard Act and state regulations.

The department's failure to ensure that vendors pay their fees results in losses to the trust fund, the consequences of which are detailed in the section in this chapter on set-aside fees. Also, the program goal of enlarged economic opportunity for the blind is not met for the failing vendor in dire financial straits. In addition, the department deprives blind vendors as a whole of a potentially successful location when it allows a vendor to remain in a location despite his or her disregard of the requirements for payment of fees and filing of reports.

The Department Has Not Adequately Managed Initial Stock Loans

The department does not enforce prompt repayment of initial stock loans, nor does it adequately evaluate credit risk when granting loans.

The department is deficient in administering initial stock loan procedures outlined in state regulations and in its procedures manual. Thirty-nine percent ($90,000) of the total loans outstanding has been deemed uncollectible. The department does not enforce prompt repayment of initial stock loans, nor does it adequately evaluate credit risk when granting loans to vendors. It also fails to charge penalties for delinquent loan repayments, nor does it charge interest on the loans. In addition, the department's use of set-aside fees for initial stock loans is contrary to federal law.

The department grants loans to vendors opening locations for the purchase of initial stock. However, it has severe problems with delinquent and uncollectible loan repayments. Out of $233,000 in outstanding loans as of December 31, 1996, $154,000 (66 percent) was over 90 days past due, including $90,000 (39 percent of the total) that has either been turned over to the Franchise Tax Board or the Board of Control as uncollectible, or is uncollectible because of vendor bankruptcies. According to state regulations, the department should make every effort to pursue collection, and if a vendor fails to pay scheduled loan repayments for more than 90 days, it is grounds for termination or suspension of the vendor's license.

We reviewed five vendors with outstanding loans to determine whether the department adequately administered the loans. Two of them had significant delinquencies. Also, our review showed that the department exercised poor judgment and inconsistently applied its procedures in making loans to vendors who already owed it money.

For example, the department approved a loan of $18,000 for a vendor even though the department knew the vendor had recently filed for bankruptcy protection. At this point, the vendor owed nearly $15,000 in delinquent fees and loans to the department. The vendor made payments against the $18,000 loan for a year, then later resigned from the program when the balance of the loan was approximately $12,800 and

The department approved a loan of $18,000 even though the vendor had an existing $15,000 delinquency and recently filed for bankruptcy protection.

made no further payments. The total amount of set-aside fees lost due to this vendor was approximately $25,000, including initial stock loans totaling $24,000 and delinquent fees of $1,000.

Also, the department approved an initial stock loan for another vendor who was already late on $3,000 in loan payments and fees. Included in the $3,000 was a $1,000 dishonored check that was approximately a year old. The new loan "absorbed" the vendor's prior late payments, thereby eliminating his delinquent status. The department stated that, in retrospect, the loan should have been kept separate from the delinquent invoice amounts, and that this situation would not be repeated.

The effect of absorbing the delinquent debts into the new loan was that the vendor was permitted to apply for a new location because he was "current" in payments to the department. However, state regulations require that a vendor who is delinquent in the payment of set-aside fees or repayment of an initial stock loan be disqualified as an applicant, although the department may waive the disqualification. Nonetheless, the department should document its reasons and apply its decision criteria consistently.

In addition, although the vendor did not report any taxes owed to the Board of Equalization on the loan application, a report provided to the department by the Board of Equalization showed a balance of approximately $38,000 for taxes, dating back to 1990, on this vendor's account. However, the department did not feel it was necessary to investigate the balance before granting a loan to the vendor. The department stated that the Board of Equalization report does not always reflect the current status of a vendor's account. For example, vendors may have legal hearings pending or may have made arrangements for payment plans for their taxes. Nevertheless, the department should investigate the current status.

State law and the department's procedures manual allow the department to grant initial stock loans using set-aside fees to existing vendors assigned to a new location. As discussed later in the chapter, federal law does not permit the use of set-aside fees for loans. Thus, the department should not have made these loans at all. Notwithstanding this, we believe the department's management of these loans provides additional illustrations of questionable judgment and shortcomings in the department's administration of the program.

If the department was going to make loans, it should have developed credit evaluation criteria and exercised discretion in granting loans. The department put trust fund moneys at risk when it granted loans to vendors who showed signs that they may not be able to repay them. Although the department has stated that it has no criteria for denying loans, it had a responsibility to exercise prudence in the use of set-aside fees.

The department is inconsistent in applying loan repayment terms.

In addition, the department is inconsistent in applying loan repayment terms. The department's procedures manual states that all loans of up to $5,000 must be repaid within one year, and loans in excess of $5,000 must be repaid within two years. However, we found the department granted loans for periods ranging up to ten years for loans over $5,000, and up to three years for loans under $5,000.

Finally, the department does not charge penalties on delinquent loan payments as required by state regulations. Further, the department does not charge interest on loans even though its procedures manual lists a 3 percent interest rate. The department has stated that it does not charge interest because the regulations do not provide for charging interest. However, although the regulations do not specifically state that the department can charge interest, we do not see that this precludes the department from charging interest.

As a result of the department's use of set-aside fees for loans, not only is federal law violated, but trust fund moneys are lost when a vendor does not repay a loan. As illustrated by the $90,000 in uncollectible loans, many stock loans are never repaid, in part because the department approves loans in circumstances with high credit-risk factors. The department's not charging interest or penalties on delinquent loan repayments deprives the trust fund of potential resources. Further, when the department does not follow its procedures on the uses and payment terms for loans, it results in inconsistent, unfair treatment of vendors.

The Department's Administration of Set-Aside Fees Needs Improvement

Certain vendors do not pay their fair share because the department's monitoring of set-aside fees is ineffective. In addition, the department could not provide an analysis demonstrating the reasonableness of the fee schedule used to collect the set-aside fees, nor has it thoroughly updated the fee schedule since at least 1979. That, combined with the department's use of a fee schedule which exempts certain vendors from fees, makes us question the equity of how the set-aside fees are assessed. Finally, the department is not using the set-aside fees it does collect in accordance with federal law.

Both federal and state laws allow the department to collect set-aside fees from the vendors based on net proceeds from each vending facility. As fees are collected, the department deposits them into the trust fund. As of April 1997, the trust fund had a balance of $3.9 million. Federal law states that set-aside funds may be used only for the following purposes: maintenance and replacement of equipment; the purchase of new equipment; management services; assuring a fair minimum return to operators of vending facilities; and benefits such as retirement or pension funds, health insurance contributions, and paid leave and vacation time.

If the department uses the set-aside funds to purchase new equipment or for management services, it receives matching federal dollars. Therefore, the department can maximize the use of the set-aside fees and the federal matching funds by maintaining modern, competitive locations.

Contrary to federal law, set-aside fees are used for initial stock loans.

The program's regulations approved by the federal Rehabilitation Services Administration (RSA), authorize the use of set-aside fees for constructing new vending facilities and for initial stock loans to vendors. However, the federal law does not allow set-aside fees to be used for these purposes. The regional commissioner of the RSA stated that it had incorrectly approved the use of set-aside fees for these purposes. This occurred when the department submitted regulations that referred to state law regarding acceptable uses that differed from federal law.

In May 1997, the RSA informed us that action was underway to rescind its approval of these regulations. While the department's use of set-aside fees for new construction has been minimal during the last two fiscal years, it has used a significant amount of these fees for initial stock loans. In fiscal year 1995-96, $252,200 was used for initial stock loans, and through April 30, 1997, of fiscal year 1996-97, $90,000 has been used. As a result, the program does not have all the money that should be available to assist vendors and to obtain federal matching dollars, thereby restricting program maintenance and growth.

The department could not demonstrate that it used an appropriately updated fee schedule. It was unable to provide documentation supporting the establishment or reasonableness of the fee schedule, or records to show that the fee schedule has been adjusted since 1979, except for an adjustment in 1992.

In 1979, the department developed a graduated fee schedule based on net income to determine the amount of set-aside fees due from vendors. Federal regulations require the department to maintain records on the method of determining the fee schedule, and support for the reasonableness of the charges. In addition, state regulations require the fee schedule to be adjusted as necessary, in conjunction with the California Vendors Policy Committee, to maintain an adequate Vending Facilities Trust Fund to allow for program maintenance and growth. State law also requires that the $1,000 minimum income, on which the vendors pay a fee, be adjusted annually to reflect changes in the cost of living.

The department only made one adjustment in 1992, when it increased the minimum amount on which vendors must pay a fee. This adjustment appears to only have been made to bring the department into compliance with state law, not because any analysis by the department indicated that the fee schedule needed to be adjusted. Additionally, the department could not demonstrate that it had reviewed the schedule in its entirety to determine if the fees were reasonable.

By not consistently reevaluating the reasonableness of the set-aside fee schedule and adjusting it as necessary to reflect changes in the cost of living, the department is not maximizing the collection of fees and the potential for federal matching funds. This in turn restricts program maintenance and growth.

The department is not sufficiently monitoring the collection of set-aside fees, nor does it ensure that all vendors are paying their fair share.

Further, because the department is not sufficiently monitoring the collection of set-aside fees, it does not ensure that all vendors are paying their fair share. Additionally, the department's lack of a control process to ensure that vendors submit accurate data makes effective monitoring difficult. As discussed in Chapter 2, certain BECs interviewed indicated that they do not verify the information reported on the P&Ls. Also, all four of the audits performed in the last two fiscal years noted that vendors were unable to provide supporting documentation for their cost of goods sold. Therefore, by not ensuring the accuracy of the data on the P&Ls, the department does not ensure the accuracy of the set-aside fees paid.

The department was unable to provide an analysis that demonstrates the current fee schedule is equitable. The department's current fee schedule charges significantly different percentages to vendors at varying levels of net income. Because all vendors have equal access to the department's services, we question the equity of the fee schedule. For example, a vendor who makes $1,100 in net income pays $99 in fees (9 percent), whereas a vendor who makes $6,900 in net income pays $3,353 (48.6 percent). Based on the fee schedule, a vendor who nets $0-$1,000 per month pays no fees. However, if the vendor increases his or her net income by $1 per month, to $1,001, he or she will pay $70 in fees, for a net loss of $69.

A significant number of locations had vendors who received benefits from the set-aside fund, even though they did not pay into it each month.

The collection of fees from only those vendors who have locations with net income over $1,000 per month is inequitable. Because vendors with locations that make $1,000 or less per month in net income pay no set-aside fees, the vendors who do pay fees are subsidizing them. Essentially, they are subsidizing substandard performance or substandard locations. A total of 76 (33 percent) of the locations averaged less than $1,000 per month in net income in fiscal year 1995-96. This indicates that there is a significant number of locations that had vendors who received benefits, such as new equipment and equipment repair and maintenance, from the set-aside fund and the corresponding federal matching funds, even though they did not contribute to the fund each month. The locations that netted more than $1,000 per month have vendors who, in effect, were charged fees for these same services.

To ensure that all vendors pay an equitable amount into the fund from which they receive services, the department should propose changes to the state law to eliminate the $1,000 income minimum for set-aside fees. Also, the department should modify its current fee schedule to ensure all vendors are paying a fair amount of fees. One possible modification would be to establish a flat rate fee schedule as currently used by the business enterprise programs in Florida and Illinois.

The Department Needs To Further Improve Its Efforts To Maximize Vending Machine Commissions

The department still is not collecting all vending machine commissions owed to the program in spite of state law and a 1995 court order requiring it to do so. To fulfill these requirements, the department must identify all vending facilities located on state and federal property not operated by blind vendors and aggressively pursue all commissions due from these facilities. Commissions are either distributed to qualifying vendors or are used as contributions to the vendors' retirement fund.

By bringing all identified vending machines under contract, the department could potentially generate annual commissions of at least $1.9 million.

In 1995, we performed a financial audit of the program and found that the department was not ensuring that it received all vending machine commissions available to the program. In its one-year response to this finding, the department stated that it had developed a plan of action to address the large number of vending machine locations recently identified throughout the State. However, it appears that, although the department has shown improvement in ensuring it receives all vending machine commissions available to it, more improvement is needed.

For example, while the department has implemented a process to identify vending machines, it needs to continue to establish contracts with the related vending machine companies. State law requires the department to actively pursue all commissions from vending facilities not operated by blind vendors. Our previous audit determined that as of July 1994, the department had identified approximately 880 vending machines, and as of May 1995, it had 35 contracts in place covering 186 of the machines. As of January 31, 1997, it had identified approximately 3,100 vending machines. The increase in identified vending machines is largely a result of the lawsuit discussed later in this chapter. However, approximately 21 months later, the department had only 151 contracts for 650 of the machines.

The department receives commissions from vending machines that are under contract and also those that are not under contract. Without contracts, it cannot determine the amount of vending machine commissions it should receive. The department reported approximately $743,000 in commissions for the period July 1, 1996 through January 31, 1997. Of this amount, approximately $232,000 was received from the vending machines under contract. Based on these numbers, the average commission received from each vending machine under contract is approximately $600 per year. If all vending machines identified as of January 31, 1997, were under contract, the department could potentially receive annual commissions of at least $1.9 million. This estimate does not include all potential commissions for the Department of Corrections or any of the potential commissions for the California State University system, the Department of Parks and Recreation concessions, or State National Guard facilities because sufficient information to estimate these commissions was not available.

According to the department, the reason there has not been more progress in establishing contracts with vending machine companies is that it has limited staff available to work in this area. The department stated it needed additional staff to remedy the overwhelming backlog of vending machine contract work. The department also acknowledged that it had only been collecting vending machine income from federal properties "on an as-presented basis" and that no significant or aggressive outreach policy had been consistently employed in collecting due from these locations. By not dedicating additional staff, the department is missing an opportunity to substantially increase contributions to the vendor retirement fund.

Further, the department has not fully complied with a court order instructing it to actively pursue and collect all vending machine income. In early 1995, four vendors and the California Vendors Policy Committee sued the department. One of the issues involved in this lawsuit was that the department had failed to actively pursue all commissions from vending facilities not operated by blind vendors.

The department has not fully complied with a court order to actively pursue and collect all vending machine income.

In August 1995, an interim order was issued by the Superior Court of Sacramento County. The order required the department to actively pursue and collect all vending machine income from vending machines located on state property and from certain state agencies. These agencies included those that were previously exempted by state regulations from submitting vending machines commissions to the department, such as the Department of Corrections penal facilities, the Department of Mental Health hospitals, the Department of Developmental Services hospitals, the Department of Parks and Recreation concessions, the State National Guard field facilities, the California State University system, the University of California system, and the California Community College system. In February 1996, however, a modification to the interim order was issued that relieved the department of its obligation to pursue vending machine commissions from the University of California system and the California Community College system.

While several of the previously exempted agencies substantially complied with the order, others did not. The department had to contact the noncompliant agencies and establish contracts to collect vending machine commissions. However, it has proceeded slowly. For example, the department has not contracted to collect the vending machine commissions from 83 of the 86 sites within the Department of Correction's Parole and Community Services Division. The department only became aware of these additional sites in early 1997, even though it should have been aware of these sites as a result of the lawsuit. Also, the department has not yet developed a strategy to collect vending machine commissions from the Department of Parks and Recreation concessions, which would add 113 vending machines. Further, as of January 1997, 17 months after the interim order, the department contacted only 33 of the 71 National Guard facilities to initiate the contracting process; as of June 1997, the department has not yet contacted 19 of these facilities.

In addition, as of June 1997, almost 22 months after the interim order was issued, the department still has not entered into contracts with the Department of Corrections to collect vending machine commissions from all prisons. Although it is already receiving commissions from a majority of the prisons, the department cannot ensure that it is receiving the appropriate amount of commissions due it without contracts.

The department has abandoned any further attempts to collect vending machine commissions from the California State University system.

The department has abandoned any further attempts to collect vending machine commissions from the California State University system (CSU). Specifically, the department and the Health and Welfare Agency have written to the CSU several times requesting that it provide an accounting of vending machine income and transfer the commissions to the department. The most recent letter was sent in May 1996. The CSU responded that despite the court action, it had no income to report, and that the vending machine commissions generated in the CSU system were for the benefit of the CSU students. Subsequently, the department informed the California Vendors Policy Committee that it had met its obligations to pursue vending machine income from the CSU and that it had no intention of initiating a lawsuit against the CSU.

We do not agree with the department's decision. With 22 campuses across the State, the CSU represents a lucrative opportunity for the vendors. To comply with the court order and to ensure that it is acting in the vendors' best interests, the department should pursue these commissions.

Additionally, the department does not have procedures in place to ensure that vending machine companies comply with the terms of the contract, such as reporting sale amounts and submitting the appropriate amount of commissions. For example, we found differences between the contracted commission rate and the actual commission rate for five of the ten vending machine contracts we reviewed. For three of the contracts, the actual commission rate exceeded the contract rate. For two of the contracts, the commission rate was less than the contracted rate.

We also noted that not all vending machine companies under contract were reporting sale amounts, which would allow the department to verify the amount of commissions paid, and that some of the companies were not even remitting the vending machine commissions. By not requiring vending machine companies to comply with contract terms, the department cannot ensure that it is receiving the appropriate amount of commissions.

The Use of Vending Machine Commissions Is Inequitable

The department does not use vending machine commissions for the benefit of all vendors as required because it has used certain commissions to fund the employer portion of the retirement plan, which does not benefit all vendors. Also, the department is inconsistent in its distribution of unassigned vending machine commissions to retirement plan participants.

When vending machine commissions are received, the department classifies the commissions into two categories: commissions owed to individual vendors and unassigned commissions. Commissions are owed to an individual vendor when he or she is operating a facility in a building with vending machines because the vending machines compete with the vendor. Commissions from vending machines that are not in competition with a vendor are unassigned. For fiscal year 1995-96, unassigned vending machine commissions totaled approximately $1.1 million. For the period July through December 1996, unassigned vending machine commissions totaled approximately $605,000.

Some vending machine commissions fund the employer portion of the retirement plan which does not benefit all vendors.

To receive a share of the unassigned vending machine commissions, vendors must be enrolled in the retirement plan and contribute 3 percent of the net income reported on their monthly P&L reports. The vendor's payment must be postmarked no later than the 25th of the month. For each month of prompt mandatory contribution, the vendor earns a point. The department disburses the unassigned vending machine income to vendors annually based on the points they earned during the year.

For example, assume that during the year a total of $1 million of unassigned vending machine commissions was available for distribution to 100 vendors with a total of 1,000 points. In this case, each point is worth $1,000. The department would distribute $12,000 into the retirement account of each vendor who has earned all 12 possible points. The department does not give vendors retirement points if their monthly contributions are postmarked after the 25th of the month, if no contribution is made, or if they are not enrolled in the plan. Also, vendors do not receive the value of their share of the vending machine commissions if they leave the program before they participate in the retirement plan for five years.

When the vendors approved a retirement plan in 1978, they authorized the department to use unassigned vending machine commissions to fund the employer contributions to the retirement plan. As discussed in Chapter 4, the department is the retirement plan administrator as well as the named fiduciary. Therefore, it has the responsibility to ensure that the retirement plan is administered in accordance with both federal and state laws.

However, the department's use of unassigned vending machine commissions conflicts with federal requirements. Federal regulations require that unassigned vending machine commissions be used by the State for certain purposes that benefit blind vendors, including the establishment and maintenance of retirement plans. The federal Rehabilitation Services Administration has stated that this means unassigned vending machine commissions are to be used for the benefit of all vendors. State laws essentially mirror the federal regulations but also include vending machine commissions on state property.

The department's use of unassigned vending machine commissions conflicts with federal requirements.

The department's use of unassigned vending machine commissions to fund the employer portion of the plan only benefits those vendors who pay the mandatory contribution by the required date. This use excludes all other vendors, including certain vendors with low income. For example, in the month of November 1996, 37 (23 percent) of the 160 vendors did not receive a retirement plan point for the month. Of the 37, 13 vendors are not enrolled in the retirement plan and therefore are not eligible to receive any portion of the unassigned commissions. Twenty-four of the 37 are enrolled but either did not remit their mandatory contribution or remitted it after the due date. Ten of the 13 vendors not enrolled in the retirement program and 16 of the 24 enrolled have an average net income of less than $2,000 a month. As a result, certain vendors who would most need a retirement plan, such as those with low incomes, are not receiving benefit from the unassigned commissions.

Although certain vendors, including some with low incomes, do not receive a point of participation, the department does give a point of participation to vendors who participate in the plan but do not earn positive income in particular months. The department does not require these vendors to contribute to the retirement plan; however, it gives each vendor a point for participation if the P&L report is received by the 25th of the month. Specifically, for the month of November 1996, the department gave a point of participation to six vendors with negative net income, even though they did not contribute to the plan for November. The department makes this exception, even though a vendor earning a positive net income of $1 or more and not contributing to the retirement plan does not receive a point for participation. As a result, the department is inconsistent in its distribution of unassigned vending machine commissions.

The department's use of unassigned vending machine commissions is inequitable because it does not benefit all vendors as required. By using the unassigned commissions as the employer portion of the retirement plan, those vendors who are not participating in the plan, who do not remit their mandatory contributions, or who submit their fees after the due date do not receive a portion of the unassigned commissions. Further, the department's use of unassigned vending machine commissions is inconsistent because it makes an exception to its mandatory contribution requirement for those vendors earning negative net income and allows them to receive a portion of the unassigned commissions while others who do not contribute do not receive a portion.

The Department Needs To Improve Its Controls Over Program Assets

The department has not always maintained adequate control of the equipment purchased for the program. For example, since 1995, the department has allowed a private food service company to use program equipment at a location developed for program vendors. It also does not promptly reconcile certain equipment inventories to its equipment records.

The department has allowed a private food service company to use program equipment at a location that was developed for program vendors.

In 1990, the Office of the Auditor General evaluated the department's internal controls over equipment used within the program and noted numerous weaknesses. In 1995, we performed a financial audit and found that, while controls over equipment had improved, more improvement was needed. In its one-year response to this finding, the department stated that it had added a staff person to track fixed assets and that a new inventory tracking system was being developed. However, while the department has made some progress in improving controls over equipment, it needs to continue its efforts.

In June 1995, the vendor assigned to operate the cafeteria in the Legislative Office Building resigned from the location. One of the department's assistant deputy directors subsequently entered into a contract with the Legislature for the period July 1, 1995, through October 1, 1995. The contract allowed the Legislature to employ a private food service company at the Legislative Office Building. The private company was to operate the cafeteria and use the program's equipment, the net cost of which was approximately $84,700. In return for the use of the equipment, the Legislature agreed to pay the department an amount equal to 6 percent of gross sales per month, not to exceed $1,650 over the period of the three-month contract.

In a letter written to one of the vendors, the department's program administrator stated that when the private food service company began operating the cafeteria, approximately three months remained in the current legislative session, and no program vendors had expressed interest in operating the cafeteria. Also, the department stated that when the agreement ended, it would meet with the Legislature and attempt to reach an agreement that met both their and the program's needs. Further, if the department was unable to reach such an agreement, it would remove the equipment and not exercise its legal priority for the location at that time.

Although it has been more than 21 months since a private company began using the program's equipment, the department has not received any payments for the use of the equipment.

The contract expired on October 1, 1995, and more than 21 months later, a private company is still operating the cafeteria with the program's equipment. The department has never received any payments from the Legislature for the use of this equipment. Further, it has not received approval from the federal government to allow the Legislature and a private food service company to use program equipment.

Federal regulations require equipment purchased with federal program funds to first be used for the purpose for which it was acquired. When no longer needed for the original program, equipment can be used for other activities not sponsored by the federal government, but only if authorized.

Moreover, the contract between the department and the Legislature is technically void because the assistant deputy director is not authorized to sign contracts on behalf of the department. The State Administrative Manual states that the authority to sign contracts is limited to those officers who have either statutory authority or have been duly authorized in writing by the agency.

If the department was unable to place a vendor at the location, it should have either sold the equipment, closed the location and moved the equipment to the warehouse, or placed the equipment with another vendor. Further, if a private company is able to operate the cafeteria and presumably earn a reasonable income, we question why the department was unable to place a vendor in this location. Because the department is allowing a private food service company to use the equipment, federal funds are furthering a private business enterprise, and program vendors are deprived of the opportunity to use the equipment to enhance their business operations.

The department does not promptly reconcile certain equipment inventories to its equipment records.

In addition, the department does not promptly reconcile certain equipment inventories to its equipment records. The State Administrative Manual requires that the department perform physical inventories of the vendors' equipment every three years. In addition, the department's Property Accountability Desk Book (desk book) requires the business services section to issue a "findings report" within a specified time frame if discrepancies are noted between the physical inventory and the equipment records. The desk book also requires the business services section to issue a final report on the inventory that either indicates that no discrepancies were noted, or that the discrepancies have been resolved. In no cases, should the final report be completed more than 72 days after the physical inventory.

We analyzed a report which details the dates of the physical inventories and inventory reports completed for each location as of April 1997. Out of approximately 230 locations, we noted 83 (36 percent) instances where the department had not completed the final report within the required 72 days. Twenty-five of these instances had no final report completed at all. In the remaining 58 instances, 24 had the final report completed 90 days or longer after the physical inventory, and 2 of these 24 had the final report completed more than one year after the physical inventory.

In the 25 instances where no final report had been issued, we noted that 21 of these locations had the physical inventory performed approximately two years or more before April 1997. The department's chief of the business services section stated that the 25 final reports were not completed because there was a staff vacancy. During this period, the department did not reassign these duties to other staff. However, as of July 1997, the department's records indicated that 24 of these locations have had final inventory reports completed and one location has been closed.

While a staff vacancy would make it difficult to perform the reconciliations in a timely manner, given the fact that a majority of the 25 incomplete inventories were over two years old, the department's failure to reassign these duties indicates a continuing weakness in the controls established to safeguard equipment. In addition, the value of performing physical inventories is diminished when too much time elapses before the results are reconciled to the equipment records.

In response to our identification of this weakness, the department has just instituted a system whereby the physical inventory dates are entered into a spreadsheet, and as the final reports are completed, they are also entered into the spreadsheet. The business services section plans to monitor the time between inventories and the final reports, and ensure that the reconciliations are completed in a timely manner. Since these procedures have just been implemented, we are unable to determine their effectiveness.

Recommendations

To improve its management of P&L reports, the department should take the following actions:

- Improve the accuracy of its database and add missing records;

- Implement procedures to improve the accuracy of the summaries of missing P&Ls it distributes to BECs;

- Reconstruct records prior to September 1995 and follow up on missing P&Ls from that period;

- Intervene when a vendor falls behind in submitting P&Ls and assist the vendor if help is needed in preparing them;

- Take action against chronically delinquent vendors in accordance with laws, regulations, and department policy;

- Ensure that P&L information is provided in a timely manner to BECs so they can promptly follow up with the vendors; and

- Estimate fees and penalties owed from vendors for missing P&Ls and record the estimated amounts as receivables.

To improve its monitoring of accounts receivable, the department should identify when a vendor is falling behind in his or her payment of fees and establish a reasonable corrective action plan, and remove the vendor from the location or take action against the vendor's license if he or she fails to comply with the corrective action plan and pay all fees.

To ensure that it appropriately administers set-aside fees, the department needs to take the following actions:

- Ensure that it uses set-aside funds only as allowed by federal law and propose changes to state law to ensure it is consistent with federal law;

- Vigorously attempt to collect all outstanding initial stock loans;

- Reimburse the trust fund for moneys that were used for initial stock loans;

- Propose legislation to eliminate the $1,000 income minimum for set-aside fees and require all vendors to pay fees;

- Modify the existing fee schedule to ensure that all vendors pay a fair amount of fees; and

- Ensure that the set-aside fee schedule is appropriately updated.

To improve its collection of vending machine commissions, the department should do the following:

- Continue its efforts to enter into contracts with vending machine companies;

- Consider dedicating additional staff to assist in establishing contracts;

- Perform an analysis to determine the costs and benefits of using moneys in the trust fund to address staffing needs; and

- Establish procedures to monitor contract compliance.

To ensure that vending machine commissions are appropriately used, the department, with the approval of the vendors, should establish a plan that would use the unassigned vending commissions to benefit all vendors.

To improve its controls over program assets, the department should take the following actions:

- Discontinue the practice of allowing a private food service company to use equipment purchased with federal funds;

- Collect the money that is owed it by the Legislature;

- Ensure that all contracts entered into with other entities are for authorized purposes and are approved by staff with the appropriate authority; and

- Promptly reconcile the results of its physical inventories with the equipment records.

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Chapter 4

The Department's Decisions on Tax-Status Issues Have Put the Vendors and the State at Risk

Chapter Summary

The department has not promptly resolved certain tax-status issues related to the program's retirement plan, thereby putting the vendors and the State at risk. Specifically, over the last 18 years, the department has administered the retirement plan as though it was a qualified plan for tax purposes, even though as early as 1990, a retirement consulting firm raised concerns that the retirement plan did not meet the requirements of a qualified plan. Consequently, vendors participating in the retirement plan may owe additional taxes plus penalties and interest to the Internal Revenue Service (IRS), and the State may owe penalties and interest for its failure to properly administer the retirement plan and follow federal reporting requirements.

On a different matter, while the department has stated the vendors are independent businesspersons, it has put the State at risk because its administration of the program raises a question regarding whether its relationship with the vendors is more like an employer/employee relationship. If it is determined that the vendors should in fact be classified as employees, the State is potentially liable for failure to provide employee benefits and withhold taxes.

The Department Has Been Slow To Resolve Problems Related to the Retirement Plan

On June 1, 1979, the department implemented a retirement plan for the blind vendors as authorized by the Randolph-Sheppard Act and developed by a private consulting firm working with the program staff and the California Vendors Policy Committee. The plan states that it should be administered according to California's laws and that it is intended to meet all requirements for retirement plans set forth under the Internal Revenue Code and the Employees Retirement Income Security Act of 1974 (ERISA). Both of these laws impose substantially identical requirements for plans seeking qualification for certain tax benefits.

The plan identifies the department as "the Employer," "the Named Fiduciary," and "the Plan Administrator," and the vendors as "the Employees." As the administrator and the named fiduciary, the department must supervise and control the plan's operation according to the plan's provisions and can make regulations for administering it as long as the regulations comply with the plan's provisions. The department must also administer the plan prudently and in the vendors' best interests.

Correspondence shows that at the time the plan was established, the department asked the state Department of General Services (DGS), whose role was to act as intermediary between the department and the retirement consulting firm, to inquire whether the department should submit the plan to the IRS for a ruling on its tax status.

Based on its discussions with the retirement consulting firm, the DGS responded that, because the vendors contributed money after taxation, the funds were not taxable when distributed. The DGS also stated that any money the department contributed and any interest from the vendors' contributions were not subject to tax yearly, but only when money was distributed.

Initially, the department was informed that its contributions to the retirement plan were tax-deferrable.

Further, the DGS informed the department that, in the opinion of the retirement consulting firm that developed the plan, it was unnecessary to submit the plan to the IRS because the program was "governmental or at least quasi-governmental in nature," "it would not help the program to have it submitted to the IRS," and "there would be no penalty to the department, to the State, or to the vendors" if the department did not file the plan. Based on a review of the available documents, it appears as though the department accepted the information from the DGS and the advice of the retirement consulting firm.

The Department Needs To Resolve Certain Tax-Status Issues

The department continues to administer the retirement plan for blind vendors as if it was a qualified plan for tax purposes despite subsequent concerns raised by the retirement consulting firm and even a preliminary finding from the IRS that the plan is not, in fact, qualified. Under a qualified plan, special tax treatment is available related to retirement contributions. One of the elements of this special treatment provides that contributions and earnings are tax-deferrable—that is, not included in the gross income of the participant until the participant actually receives a distribution from the plan.

As far back as 1990, the department was aware of the possibility that the retirement plan may not qualify under IRS provisions, thus placing vendors at risk of owing additional income taxes.

Even though the retirement consulting firm through DGS originally told the department the plan was tax-deferrable, in 1990, the firm raised concerns that the plan did not meet the requirements of a qualified plan. Specifically, the firm expressed concern that the plan did not fit into any of the structures afforded tax-favored status under federal law. Moreover, it warned that if the plan was not "tax-advantaged," contributions and earnings would be currently taxable. If currently taxable, plan contributions and earnings would be reported as income on the vendors' annual income tax returns.

As far back as 1990, then, the department should have realized the possibility existed that the vendors could owe additional income taxes, plus penalties and interest, because of the department's failure to properly administer the plan and follow the Internal Revenue Code. Also, the department should have realized the State could also potentially owe penalties and interest as a result of its own actions.

The department did attempt to get an IRS ruling on the plan's tax status in 1992. However, it failed to follow up on the ruling as soon as it should have, thus potentially increasing the financial liability to both the State and the vendors.

Specifically, on January 23, 1992, through an outside law firm, the department sent a letter to the IRS requesting a ruling. In its response dated July 1992, the IRS Washington D.C. office declined to make a ruling because the issues were not under its jurisdiction but recommended the department submit the plan to the IRS Employee Plus and Exempt Organizations division. However, the department did not do this until March 31, 1995, nearly three years later. Although the department could have made changes to the plan after it had been resubmitted to IRS, it stated that the three-year delay primarily occurred because it gave the California Vendors Policy Committee (committee) an opportunity to review certain proposed changes. The committee then turned this matter over to its legal counsel who, almost a year and a half later, suggested other amendments to be made to the plan. However, the department eventually submitted the plan to the IRS without amendments from the committee. The IRS replied in September 1995, stating that unless the department could provide compelling facts to counter its preliminary finding that the plan was not qualified, it would issue in approximately 30 days its findings in an "adverse determination letter." In response, the department sent additional information to clarify its position.

However, as of June 1997, the department has not received a final decision from the IRS. While waiting for the ruling, the department's law firm has attempted several times to contact the IRS and to provide any additional information it might need. Nonetheless, more than seven years have passed since the department was first informed of the plan's tax status problems, and despite the potential that tax penalties and interest may have continued to accrue over this time, the issues remain unresolved.

Because of the vendors' and the State's continuing risk of incurring penalties and interest, we believe it is crucial the department resolve this matter as soon as possible.

The Department's Administration of Vendors' Employment Status Raises a Question

The department has further put the State at risk because there is a strong potential that vendors could be classified as employees of the State, even though the department has stated the vendors are considered to be independent businesspersons. Some of the procedures used by the department in administering the program indicate that the department's relationship with the vendors is closer to that of employer/employee. If the vendors are indeed considered employees of the department, there could be a substantial liability to the State for meeting its legal and financial responsibilities.

Some procedures used by the department to administer the program may indicate an employer/employee relationship.

Federal and state statutes do not provide any specific guidance as to whether the vendors should be classified as independent contractors or employees of the State. This determination is the responsibility of the individual state agency and taxing authorities applying California case law. The outcome of this determination is important because in either case there are significant issues that need to be addressed. These issues include whether the State is responsible for withholding appropriate taxes and providing the vendors with unemployment insurance and various employee benefits, such as vacation and sick leave. Classifying vendors as employees versus independent contractors would also impact the administration of the vendor retirement plan.

Because of the complexity involved in assessing employment status, we asked our legal counsel to determine whether the vendors are employees of the State or independent contractors. We also asked our legal counsel to determine the potential liability to the State, if any, based on that determination.

According to our legal counsel, the independent contractor/employee test under California law is based upon several criteria, which are analyzed in conjunction with the facts of each situation. Also noted was that this particular case was difficult to analyze because of the unique nature of the program, the provisions of the Randolph-Sheppard Act, and the factors do not weigh conclusively in either direction. However, our counsel found that there are some factors which tip the balance in favor of an employee relationship between the vendors and the State.

In applying California law, the most important factor in analyzing the independent contractor/employee relationship is the department's right to control the manner and means the vendor applies to achieve the end result.

The most important factor in analyzing the independent contractor/employee issue is the department's right to control the manner and means by which the vendor reaches the end result. The department has the right to exercise, and in many cases exercises, a substantial degree of direction and control over the vendors. Although the Business Enterprise Consultant in many respects is only providing assistance, the vendor agreement, in conjunction with the agreement between the department and the building management, gives the department the authority to oversee hours, prices, merchandise sold, equipment purchases, maintenance, and staffing of vendor facilities. The department's right to control day-to-day business operations is more akin to that of an employment relationship rather than an independent contractor or licensee/franchisee relationship.

Also, the department insures the vendors for liability and workers' compensation through the State's Business Enterprise Program master insurance policies. The department requires the vendors to reimburse the State for these insurance costs as part of the monthly profit and loss (P&L) reporting process. However, as discussed in Chapter 3, the department does not ensure that it receives all monthly P&Ls, and it does not collect all fees due from vendors. Therefore, it is providing liability and workers' compensation insurance for those vendors who do not submit P&Ls and fees.

In addition, the department has the right to employ progressive discipline measures in dealing with vendor problems. Again, this is similar to an employment relationship. In an independent contractor setting, the principal does not employ progressive discipline. Instead, the principal can only accept or reject the agent's work product; that is, the principal either continues the relationship or terminates the contract.

A significant factor in characterizing the department's relationship with vendors as employer and employee is the existence of the state-administered retirement plan, which refers to the vendors as employees and the State as the employer. Also, although the department does not currently provide for paid vacation or sick leave for the vendors, state law allows for set-aside funds to be used for these purposes. In an independent contractor setting, the agent is responsible for his or her own benefits and retirement.

The retirement plan identifies the vendors as employees and the State as the employer.

Moreover, state regulations contain numerous other instances that provide the department with the ability to exercise control over the vendors. This right to exercise control is also contrary to an independent contractor/principal relationship.

Several secondary factors exist that favor an employee relationship. These include the length of the relationship between the department and the vendor, i.e., many vendors can remain in the program until they reach retirement age; the skill required in the occupation, i.e., the department provides vendors with an initial six-month training program and ongoing training during the course of their vending careers; and establishing vendor locations as part of the normal function of the department, i.e., the department identifies potential locations and subsequently contracts with building management to establish a vending location. Furthermore, the retirement fund receives money from vending machines that are not controlled by program vendors. As a result, vendors are receiving benefits beyond their contributions.

Another key component of this analysis is who bears the financial risk when the business is losing money. Our legal counsel found that, while this risk appears to rest upon the vendor, it is partially negated because vendors who earn less than $1,000 in net income per month are not required to contribute set-aside fees. It is also negated in cases where vendors fail to reimburse the State for insurance coverage, as the State bears some of the vendors' operating costs. Thus, the department bears some risk of loss, and vendors may receive benefits from the set-aside funds in excess of their contributions. All these facts favor an employment relationship.

The department's chief counsel states that employee status depends upon the law in each situation and that vendors, as participants in a government-sponsored program, are unique. Additionally he stated that the vendors are independent businesspersons rather than department employees. Although the vendors have agreements with the department, the department's chief counsel contends that the vendors are unlike the independent contractors in cases that distinguish between employees and independent contractors. He believes this because, in the department's view, it provides services to the vendors; the vendors do not provide services to the department.

We are not convinced by the department's argument because the chief counsel has not demonstrated that a unique category of independent businessperson exists as an alternative to employee and independent contractor when considering this matter. Further, the department's own outside attorneys have referred to the vendors as independent contractors. Thus, we believe that, since a potential liability exists, it is appropriate for the department to review the vendors' employment status using established criteria that distinguishes an employee from an independent contractor.

The State could potentially be liable for failure to provide benefits and failure to withhold statutory taxes.

Our legal counsel concluded that the State could potentially be liable for failure to provide certain employee benefits and to withhold certain statutory taxes. The vendors may also have an argument that, as state employees, they would be entitled to participate in the state-administered Public Employees' Retirement System or its deferred compensation program. Because there are numerous factors that impact tax withholding and employee benefit issues, the amount of possible liability to the State cannot be determined. However, the liability in this area could be substantial.

Recommendations

To minimize the potential financial risk to both the vendors and the State, the department should take the following actions:

- Work to resolve the retirement plan issues as quickly as possible;

- Perform a thorough review of the status of the vendors as state employees or independent contractors; and

- Implement those modifications that will ensure that vendors are treated as intended.

We conducted this review under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in this report. The information in this report was shared with the department, and we considered its comments.

Respectfully submitted,

KURT R. SJOBERG
State Auditor

Date: August 27, 1997

Staff: Karen L. McKenna, CPA, Audit Principal
Alison A. Hanks, CPA, CGFM
Kenneth Cools
Margaret M. Junker
Marianne Marler

Appendix A

The Department's Actions on the August 1995 Financial Report Prepared by the Bureau of State Audits

Recommendations:	Department's Actions:
1. The department should develop procedures to ensure that all vendor fees are identified and collected promptly. Further, the department should continue to ensure the vendors' monthly reports are received, accurate, and supported by adequate documentation.	The department has established a centralized tracking system to track the vendors' submittal of P&Ls, vendor fees, and loan repayments. However, more improvement is needed. See Chapter 3 for further discussion.
2. The department should develop a plan to enter into contracts with vending machine companies or other appropriate parties, or both, to ensure all commissions from vending machines on state and federal property are secured for the program.	The department has increased its number of contracts with vending machine companies and has increased its collection of vending machine commissions. However, more improvement is needed. See Chapter 3 for further discussion.
3. The department should adjust the coding of expenses for parts and materials to ensure that only allowable costs are charged to federal programs. The department should develop a plan to repay the amount overcharged in the event the federal government requests repayment.	The department has stopped charging federal programs for parts and materials and has disclosed a contingent liability for the amounts on its year-end financial reports.
4. The department should better analyze its records at year-end to ensure it accurately identifies and accrues all liabilities for goods and services received before, but paid after, June 30.	The department accrued actual and estimated liabilities and expenses on its June 30, 1996 financial reports.
5. The department should promptly reconcile the results of its physical inventories with the property and accounting records.	The department has not always promptly reconciled physical inventories to the equipment records. In early 1997, the department implemented a new monitoring system. See Chapter 3 for further discussion.
6. The department should segregate incompatible duties to provide an adequate level of internal control.	The department has improved its segregation of incompatible duties.

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Appendix B

Vendor Questionnaire

To obtain vendor input regarding the administration of the program, we mailed a survey to all 205 licensed vendors in the State. A total of 117 vendors responded to the survey.

Below are summarized results of the key questions on the vendor questionnaire:

	Yes	No	No Reply
Does the income you receive allow you to be self-supporting?	65.8%	32.5%	1.7%
Do you believe that there are adequate opportunities for upward mobility?	59.0%	40.2%	.8%
Do the services provided by the Business Enterprise Consultant (BEC) meet your needs?	59.8%	38.5%	1.7%
Was the initial training when you first entered the program relevant and helpful?	85.5%	12.0%	2.5%
Did you find the ongoing training provided by the department helpful?	27.4%	8.5%	64.1%
Are you allowed enough flexibility to operate a successful business?	60.7%	31.6%	7.7%
Is the California Vendors Policy Committee fulfilling its role as advocate?	59.0%	30.8%	10.2%
Is the program meeting your needs overall?	70.1%	27.3%	2.6%

We also asked the vendors open-ended questions, including the ones listed below. We considered the responses during our testing and quoted several responses in Chapters 1 and 2.

What types of services do you receive from your BEC?

What other services do you believe would be most beneficial?

Please identify the types of ongoing training you have received.

How many times did your BEC visit your facility last year?

What was the focus of the BEC's visits to your facility?

How do you believe the program could be improved?

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State of California - Health and Welfare Agency PETE WILSON, Governor

DEPARTMENT OF REHABILITATION
830 “K” Street Mall
P.O. Box 944222
Sacramento, CA 94244-2220
(916) 445-7238
FAX (916) 324-2026

August 8, 1997

Kurt R. Sjoberg
State Auditor
Bureau of State Audits
660 J Street, Suite 300
Sacramento, CA 95814

Dear Mr. Sjoberg:

Enclosed is the response to your report entitled “Department of Rehabilitation: Poor Management Practices Limit the Effectiveness of the Business Enterprise Program for the Blind” performed in accordance with Section 19640.5 of the California Welfare and Institutions Code. Thank you for the additional two days to respond to the report.

If you have any questions regarding the response, please contact Russ Enyart at (916) 322-6869.

Sincerely,

Brenda Premo
Director

cc: Sandra R. Smoley, Secretary
Health and Welfare Agency

Note: The department’s response has been reformatted for inclusion in the report.

Summary

Based on principles of sound public policy regarding the appropriate use of limited resources, the Department of Rehabilitation (department) disagrees with many of the findings and conclusions in the Bureau of State Audits' (BOSA) report on its audit of the department's Business Enterprise Program (BEP). The department acknowledges that there are problems within the BEP and believes that changes to the program as a result of certain audit findings will prove to strengthen the program. On the other hand, many of the findings and recommendations, when viewed from an overall public policy perspective, illuminate the problems inherent in a program which is outmoded and out of step with the impending 21st century. 1 2*

3

The BEP was authorized in federal legislation in 1936. At that time, it was believed that individuals who were blind could accomplish little in terms of employment. The BEP provided an employment opportunity, similar to the sheltered workshop programs for individuals with physical and developmental disabilities that were prevalent in the 30s and 40s. It was a program designed to provide continued support for individuals who were blind, and, although the intent was to assist them to become more independent, it has created an expectation of continuing dependency upon public funding to maintain their employment. 3

The BEP is not a typical governmental social service program. It is first a rehabilitation program designed to assist individuals who are legally blind to become employed and more self-supporting. Second, it is a subsidy program for the businesses (vending facilities) of these individuals. Third, the program has administrative responsibility for 220 food service locations, which in effect involves a governmental agency engaged in one of the most highly competitive and volatile businesses in today's marketplace. The laws and regulations governing each of these three components, as well as the necessary administrative competencies are often in conflict. When administering this program it is difficult to "strike a balance," as suggested by the Audit Principal.

The BEP is primarily funded with federal funds pursuant to Title I of the Rehabilitation Act, as is the entire Vocational Rehabilitation (VR) program. A primary difference between the traditional VR program and the BEP is the length of time that support is provided by the department. For a typical VR client, services usually end when the client has

*The California State Auditor's comments on this response begin on page 115.

been successfully employed for 90 days. Services for a BEP vendor continue as long as the individual elects to remain a vendor, often for a period of 20 or more years.

The proportion of resources currently dedicated to this 3
program which serves a relatively small population is already substantially greater than those received by the much larger population of clients served by the department's VR program. BEP is a very costly program, averaging $43,550 per year per BEP vendor, as compared to an average case service cost of approximately $1,500 per year per VR client. Funds spent or encumbered for BEP in Fiscal Year 1996/97 totaled over $8.2 million to serve 189 vendors/trainees. The total VR program budget, including staffing costs, to provide a full range of services to more than 100,000 clients, was $257 million.

While the BEP continues to create a dependency for these 189 individuals by providing ongoing support to both the vendors and the vending facilities, in Fiscal Year 1996/97, the VR program provided services to enable more than 11,000 individuals with disabilities to become successfully rehabilitated and gainfully employed.

The department has 36 staff assigned to the BEP section solely to provide services to vendors and new clients entering the program. With 189 vendors/trainees, the vendor to staff ratio in the BEP is approximately 5.3:1. There are also 6 to 8 staff within Administrative Services providing additional administrative support for the BEP. By comparison, the client to staff ratio for the general VR program based on all administrative and direct service filled positions is 75:1.

Continuing to dedicate this substantial amount of resources to the BEP is contrary to current public policies and the basic philosophies of delivering health and welfare services, especially for individuals with disabilities. Today's programs, such as welfare reform and the general VR program, are not entitlement programs, and are focused on providing time limited support and services which enable individuals to become independent. The BEP, on the other hand, provides ongoing support services throughout the term of employment. Today, individuals with disabilities, including persons who are blind and partially sighted, have a variety of career opportunities that do not require public support. They are employed as computer programmers, lawyers, analysts, cabinet makers, disc jockeys, artists, school teachers, clerical workers, and department directors, such as the director of the Department of Rehabilitation, who is legally blind.

The BOSA recommends increased outreach to all individuals who are blind throughout the state of California to promote the BEP. At a time when the Department of Rehabilitation is not able to serve all eligible individuals due to limited resources, encouraging additional individuals to pursue an employment opportunity at a continual cost of $40,000 per year is unreasonable. Although the department takes outreach seriously, the department wants to assure that individuals with severe disabilities, including those who are blind, are aware that there are many options for employment. The department, while offering the BEP as an option, does not want to imply, nor should it, that the exclusive career path for an individual who is blind is to become a BEP vendor. 4

The department will continue to work within existing resources to strengthen the BEP and to comply with legislative and regulatory mandates. At the same time the department will work with the Administration and the legislature to find ways to better serve the citizens of California who are blind to enable them to obtain and maintain employment that will maximize their independence, rather than create a continued dependency on public resources. It is important that we assist individuals with disabilities to pursue career choices that will enable them to become independent, contributing members of their communities.

Introduction

Although the Introduction primarily contains background and statistical information, this section of the audit misrepresented the profitability of California's vendors. The BOSA compared profit information based on location type, rather than based on vendors, to the national average, and depicts California's program as substandard in profitability. This comparison failed to show that the average net income per vendor in California for the 1994-95 fiscal year ($31,502) exceeded the national average ($26,420). Properly analyzed, the net income of California vendors exceeded the national average by 19 percent in that fiscal year. 5

The Department's Promotional Efforts Are Insufficient (page 1-1)

The department disagrees with this finding. The BOSA believes the department's promotional efforts will not be sufficient until "the department can ensure that all blind people within the State are made aware of the program ..." 4 This finding assumes that all "blind people" in California desire a career in food service and if made aware of the BEP they would immediately apply for services at their local rehabilitation office. More significantly, the standard established by the BOSA ignores the fact that the department is currently unable to serve all eligible VR clients due to limited funding.

The department's outreach efforts are appropriate when considered in light of competing demands for department resources. VR clients of the department are made aware of the BEP through a proactive approach. Every VR counselor is made aware of the BEP during their initial training with the department and have access to BEP regulations through the automated resource library. In addition, Rehabilitation Counselors for the Blind are presented information on the BEP on a regular basis by the BEP Administrator and by the Chief for Services to the Blind and Partially Sighted.

The BOSA has supported its finding based on one counselor who indicated she was unaware of the program. 6 It has not provided any other evidence to support their assertion that the other counselors who serve clients who are blind or partially sighted are unaware of the BEP as a potential career choice. Further, the single counselor BOSA identifies as not being aware of the program made this statement regarding her knowledge of the program in 1993. The department took steps in 1994 to ensure every counselor is aware of the BEP by including it in the department's orientation for new employees.

Moreover, the department makes information packets available to all interested parties. These packets contain information on the program and the requirements to become a BEP vendor.

Note: Page numbers have changed

The Department Believes Certain Regulations Are No Longer Appropriate (page 1-3)

The department agrees with this finding. The BOSA stated that the department believes regulations requiring vocational and medical evaluations are no longer appropriate, but that the department has not yet proposed regulations to remove these requirements. In addition, the BOSA suggested that before the department takes any action to change the regulations it should ensure that they are not a necessary component in determining an applicant's potential for success in the program.

The department agrees that current regulations requiring 7
medical and vocational evaluations are no longer appropriate. The 1992 Amendments to the Rehabilitation Act encourage the use of existing information, including reliance on information provided directly from the individual with a disability. Therefore, the disability of blindness is often apparent, and would require only documentation of legal blindness for acceptance into the BEP. Individuals can often describe their interests and functional capacities which would eliminate the need for any specific vocational evaluation. However, the department delayed making regulatory changes until the Rehabilitation Services Administration promulgated the federal regulations providing guidance for the implementation of these amendments. The final regulations were not published until February 11, 1997, becoming effective March 13, 1997.

The amendments and regulations now in place require that individuals with disabilities be provided information to allow them to make "informed choices" and to be given opportunities to pursue careers. Unless a career choice is contraindicated, the VR counselor will generally give the client the opportunity to "test" their capabilities in working toward their vocational objective. For BEP clients, that first step would be the training and on-site assessment completed by the BEP. Upon referral to the BEP, the Applicant Review Panel reviews all appropriate information provided by the VR counselor, and ensures, to the extent possible, that each applicant is prepared to enter the program.

The Department's Location Development Efforts are Inadequate (page 1-4)

The department disagrees with this finding. With existing 8
staff, the department has established the following new vending facilities since February 1995:

- Municipal Courts Vending Stand
  Dry Vending
- U.S. Post Office Vending Stand
  Vending Machines
- State Library/Courts Annex
  Vending Machines
- Dept. of Social Services
  Vending Machines
- Dept. of Justice Hdqrts
  Cafeteria
- Secretary of State
  Cafeteria
- Internal Revenue Service Center
  Cafeteria
- Aliso Creek Roadside Rest South
  Roadside Rest/Vending
- Aliso Creek Roadside Rest North
  Roadside Rest/Vending
- U.S. Post Office, Bulk Mail
  Vending Machines
- Insignia Corp of Engineers
  Wet Vending
- Defense Finance & Accounting
  Snack Bar
- U.S. Postal Service
  Vending Machines

The finding also notes that the department must have
larger, more complex, and more profitable locations avail-
able for vendors to achieve upward mobility. The depart- 9
ment disagrees for two reasons. First, the finding incor-
rectly equates higher profitability with large, complex
vending facilities. The large, complex locations (cafeterias)
are not viewed as an upward mobility opportunity by ven-
dors, and often only new vendors compete for these loca-
tions. The most desired and profitable locations, vending
machine locations, are the least complex. Secondly, ac-
cording to the survey (see Appendix B to the report) con- 10
ducted by the BOSA nearly 60% of the vendors who com-
pleted the survey believe there are adequate opportunities
for upward mobility in the BEP.

The finding also notes that state and federal laws encourage the establishment of vending locations on private, county, city, or other political subdivision property. To the uninformed reader it may appear that the department has not established facilities on such properties when in fact it has more than 50 locations on county property. The number of these locations is even more significant since the BEP does not have a priority on these locations, unlike state and federal properties, and must compete to obtain these sites with other food service providers.

More Aggressive Location Development Efforts Are Needed
(page 1-5)

The department agrees, in part, with this finding. This finding indicates that the department should seek out untapped opportunities for potential BEP locations, such as U.S. Department of Defense (DOD) facilities, popular destinations for the public, or move into other areas of merchandising, such as gift shops.

The department agrees that the BEP should maximize the locations available to the program, consistent with the
resources available to it. However, to fully appreciate the (11)
fallacy of the BOSA's finding one must consider the program's program's priority, its focus and the market in which it competes today. The BEP has a priority over private service providers in obtaining facilities on state and federal property. Vendors are not required to pay rent or utilities at these locations. These locations, together with substantial BEP staff support, have provided many vendors the opportunity to earn a living and operate an independent business. Although these sites continue to make up the majority of BEP's locations, there have been changes over the past several years which have negatively impacted vendor earnings. Government downsizing, telecommuting, flex-time, and restricted public access to buildings have all contributed to a decrease in profitability for vendors who operate vending stands on government property, despite the subsidized rent and utilities expenses for such locations.

While the BOSA notes this downtrend in its report, it indicates the program should seek out locations other than those on state and federal property with a view toward "profitability." Among the locations they mention are "popular destinations for the public." Popular destinations for the public, which might include government facilities for which BEP may have a priority, are locations also most coveted by corporate food giants. The BEP, a government-administered (11) program encumbered by federal and state laws and regulations, and control agencies, does not have the resources or expertise required to compete on a level playing field in one of the most competitive and volatile businesses in today's marketplace. If that were the case, the BEP would not need the protection of the Randolph-Sheppard priority in state and federal buildings.

The department does seek out opportunities for BEP vendors, but to aggressively pursue all potential locations that (12) could become a BEP facility as the BOSA suggests would necessitate the redirection of program resources. Moreover, to develop the expertise to begin operating facilities such as gift shops will require a shift in emphasis and program operation which will decrease availability of BEP staff currently dedicated to the management of 220 existing BEP food service locations.

The BOSA also noted that the department has displayed a (13) lack of initiative in pursuing DOD locations. The department does not agree with this finding. The department has been involved in the review and pursuit of DOD locations since February 1996. There are a number of issues that must be addressed prior to entering into a contract that carries with it a great deal of responsibility and potential liability for the department and the state. Many of the DOD facility contracts are for millions of dollars, and as signator of such contracts the department is potentially liable to DOD in the event of a contract breach. In addition, the department is evaluating its capability to effectively administer such contracts and to provide the assistance and support to DOD dining facility vendors who will be responsible for adhering to detailed and exacting military food service standards, and is exploring the process for hiring consultants with expertise to assist the department. Other states, Texas and Alabama for example, have encountered significant litigation expenses in connection with the DOD selection process. In addition, the BEP must manage its current locations while exploring additional sites.

This finding also proposed combining of locations as another means of creating viable locations. Unfortunately, (14) the regulations and procedures governing the BEP which provide guidance for the combining of locations are in conflict on this issue. The department recognizes there must be more program flexibility in this area and is focusing attention on this issue as it promulgate new BEP regulations.

The finding also states that the BEP did not take advantage of an opportunity to combine locations in the capitol area of Sacramento to form a coffee cart route. 15 The department does not agree with this finding. The BEP did evaluate a coffee cart route in 1996. Among the departments requesting this service, Food & Agriculture and the Legislative Office Building demanded that the BEP furnish full food service for their locations, both of which had earlier been determined not to be financially viable. The remaining locations, because of their building population, were questionable sites for a coffee cart route. Subsequent to the BEP's decision not to install coffee carts in these buildings, Education contracted for a coffee cart that has since been removed for lack of business, which confirms the BEP's analysis that there was insufficient population to support this type of operation.

The last finding in this section indicates that the BEP should develop creative solutions to its shortage of profitable vending locations by assigning a coffee cart or hot dog stand to existing lower-earning locations. The BEP is 16 exploring the development of regulations and procedures that give the program authority to assign such locations, in lieu of a competitive process.

The Department Has Not Demonstrated That It Has Established Vending Facilities In All Feasible Locations (page 1-8)

The department agrees, in part, with this finding. This finding states that the department does not always sufficiently document its analysis of the viability of potential vending locations. While the department agrees that some form of documentation should be included in the file, there are some locations that do not require extended analysis to determine they are not financially feasible.

The department takes issue with the examples cited in the report regarding locations that were not pursued by the 17 BEP. The information highlighted in the BOSA report on the potential theme park/hotel/restaurant location does not provide a complete description of the events surrounding this location. The BEP Administrator of Arizona contacted the department with information on a potential site that would border Arizona and California.

The Arizona Administrator had been negotiating with an existing restaurant/hotel company that was looking for venture capital to develop a theme park. It was determined, through discussion between the department's BEP Administrator and the Arizona Administrator, that the upfront capital and ongoing profit allowance would impose an enormous financial burden on the respective programs. For these reasons this location was not pursued further, either by California or Arizona. It should be noted that the restaurant/hotel company has not yet developed the theme park although it is still searching for venture capital to do so.

The utility district location referred to by the BOSA was 17
determined not to be feasible after a review of the conditions set forth by the utility company. Based on the information given by the utility company, the snack bar would have been feasible only if the utility company provided the space without charging for rent or utilities, and allowed the vendor to provide the vending machine service to the building. The BEP was told by the utility company representative handling the negotiations that those items were not negotiable. Based on that information the BEP did not continue to pursue the location.

The BOSA also states the department should be using a report required by state law to identify potential vending locations. The report acknowledges that the department has not prepared this report in reliance on the paperwork reduction act. Still, the BOSA concludes the department is required to prepare this report because "the report in question is primarily prepared for the [vendors'] committee." The department does not agree that the report is 18
"primarily" prepared for the committee. The statute requiring the biennial update of this report, Welfare and Institutions Code Section 19640(d), states "(t)he report prepared by the department pursuant to this section shall be updated on or before January 1 of every even-numbered year, and this biennial update shall also be submitted to the committee of licensed blind vendors and the Legislature." The statute does not indicate that the report is primarily for the committee.

Finally, the BOSA points out that 53 percent of the vendors responding to its questionnaire (see Appendix B to the report) expressed the opinion that the program needs more 10
locations and better business opportunities. At the same time, nearly 60 percent of the vendors responding to the questionnaire felt there were adequate opportunities for upward mobility in the program. The inference may be

drawn that while most vendors believe they have adequate opportunities for upward mobility they, like all business people, would like to have more opportunities.

The Department Has Taken Some Positive Steps in Location Development (page 1-11)

The department agrees that it has taken positive steps in new location development.

The Department Should Actively Explore Possibilities for Expanding Business Opportunities (page 1-11)

The department agrees that expanding business opportunities for vendors would be beneficial.

This finding recommends that the department strive to
identify and implement new and lucrative opportunities for
its vendors, by leaning away from cafeterias and focusing
its energy on such things as espresso carts, hot dog carts
and vending machines. The department notes that this
finding is in direct conflict with the finding titled **The**
Department's Location Development Efforts Are Inad- 19
equate, wherein the BOSA stated the department "must
have larger, more complex" locations for vendors.

Nevertheless, the department has been focusing its energy on more lucrative, but less complex locations for vendors, especially vending machine locations. These efforts have generated many highly profitable locations, and through the recent interagency agreement with the Department of Corrections, there will be additional vending machine locations in the near future.

The last finding in this section states that the department
does not explore possibilities for expanding existing loca-
tions. The department takes exception to this finding. 20
Current negotiations with Los Angeles County on its Master Contract, which began prior to the BOSA audit, for 43 BEP vendors at county locations has as one of its central themes an expanded service and product line, including passport photos, fax and reproduction services, bus token sales, prepaid phone cards, dry cleaning services, floral sales and other services. Additionally, the department has added espresso machines to existing facilities. Where a need is indicated, the department has and will take appropriate action to ensure that need is met if it is within the capability of the program.

The Department's Interim Location Process Needs to be Modified (page 1-13)

While the department agrees with the title, ***The Department's Interim Location Process Needs to be*** ㉑ ***Modified***, it strongly disagrees with the actual findings within this section.

The finding indicates that the department has not developed a "fair process" to award interim locations. The department does have a process for awarding interim locations. The BOSA subjectively concludes, however, that ㉑ the process is not fair because there is no competitive bidding process that would provide all vendors the opportunity to apply.

The process for assigning interim locations is contained in the BEP Procedures Manual. The first step is to determine if vendors on the interim location list are current on their financial obligations. The list is then ranked in the order of financial need. Using these criteria the Supervising Business Enterprise Consultant makes a fair and impartial decision as to which vendor shall operate the location. This process is an equitable process for assigning an interim location.

The regulations define an interim location as "a location which is temporarily assigned to a vendor for a maximum period of six months." In 1994, the department realized that some interim locations were being operated by the same vendor in excess of six months. At that time the department implemented a policy that an interim location was to be assigned to a vendor for no more than six months. In a legal action challenging that policy, the U.S. District Court concluded that the definition did not preclude consecutive interim assignments to the same vendor. Shortly thereafter, three vendors filed a grievance challenging the department's policy regarding interim locations. As a result, on December 7, 1995, the department entered into a Settlement Agreement allowing vendors to operate interim locations for consecutive periods of six months or less, until such time that new or amended regulations were promulgated, or the location no longer met the criteria for an interim location. The current ㉑ interim location process is based on the above settlement agreement. The department is drafting regulations to address the process for assigning interim locations.

The BOSA provides one description of an interim location as one that the department may classify, regardless of income potential, an interim location if "it does not have enough time to send out the location announcement..." This implies that the department has been negligent in (22) putting these locations out to competitive bid because it failed to plan for the competitive process. This is not the case. This process is used to remedy emergency situations, such as a vendor's death, when there is not sufficient time to complete the competitive selection process.

The BOSA notes there are currently nine locations averaging more than $2,000 per month in net income that have not been circulated as primary locations. Locations that average monthly net income in excess of $2,000 should be circulated as permanent locations but circumstances may impact the circulation of locations. Of the nine cited examples, two are currently being circulated, two are now (23) permanent locations, and another has not consistently maintained the $2,000 level. The remaining four locations will soon be circulated as permanent locations.

In its last finding in this section the BOSA is confused (24) regarding the operation and circulation of interim and permanent locations. The BOSA states "(i)f the department circulated the interim location to all vendors as a primary location, the interim vendor who is currently operating a primary location would be ineligible to apply because the department's current policy does not allow vendors to operate multiple primary locations." It is true that the department's policy is to allow a vendor to operate only one primary location. This policy does not preclude a vendor who has a permanent and interim location from competing for a different permanent location as the BOSA mistakenly suggests.

In this finding the BOSA contradicts a finding in an earlier section regarding business opportunities for vendors. In (25) the section titled ***More Aggressive Location Development Efforts Are Needed*** the BOSA notes that the "dwindling number of vending locations represents decreased opportunity for vendors." Yet in this finding the BOSA takes issue with the department's policy to allow a vendor to operate only one primary location saying "based on our review of laws and regulations, we believe there are no restrictions on the number of primary locations a vendor may operate." This suggests that the BOSA is in favor of a vendor having multiple primary locations which would decrease the opportunity for other vendors to participate in the program.

Chapter 2

The Department Is Not Fulfilling Its Responsibilities in Providing Vendor Advice and Assistance

Initial Training Course Appears Adequate To Prepare Applicants for the Program (page 2-1)

The department agrees with the BOSA's assessment of the initial training program.

The Department Offers Limited Opportunities for Ongoing Training (page 2-2)

Although the department agrees with the title of this finding, it disagrees with the BOSA's assessment that the ongoing training provided by the department is inadequate. The BOSA reports "the department is required to provide in-service training to improve vendors' current operations and upward mobility training to increase vendors' skill levels to become qualified to operate larger, more complex vending facilities."

However, the BOSA unfairly discounts the value of the 26
department's initial training program, specialized classes, self-study courses and the consulting services provided by Business Enterprise Consultants (BEC) as ongoing training. BOSA also contradicts itself by first indicating the trainer, the curriculum, and the continuous monitoring of trainees appear adequate to prepare a qualified trainee to operate a vending facility while also asserting that the components of this training program are insufficient to provide a vendor with the skills to operate larger, more complex vending facilities.

The department provides an in-depth training program for clients entering the BEP. A structured, six month training program along with an on-the-job training component prepares each new vendor for a food service career. By the BOSA's own admission, the training program is facilitated by an individual with "an extensive background in the food service industry" and has "(o)ver the last four years incorporated material from the National Restaurant Association's (NRA) management program." As with most training programs, each session is refined and enhanced to provide current information regarding the food service industry. Vendors who have been selected for a location can attend individual components of the initial training program to assist in their ongoing personal development. It is the department’s position that experienced vendors can benefit from attending sessions of the initial training program which include updated information since the vendor was originally trained.

The BOSA ignores the reality that once a trainee has 27
successfully completed the training program and the vendor has been selected for a location is no longer a department client, but an independent business person. The BOSA neglected to consider the responsibility of these independent business persons to seek out and attend training to enhance their skills.

The BOSA implies in its report that classes in tax prepara- 28
tion and new tax laws should be made available to the vendors by the department. The department has no obligation to assist vendors with the preparation of personal income tax reports. Vendors, as sole proprietors, are responsible for locating and attending any training on tax laws and tax preparation to file their personal income tax reports.

Although the department offers a variety of other training opportunities, including classes in vending machine repair, self-study materials and individual consultation, the de-
partment should not be considered the sole provider of 27
training to these independent business persons. There is a multitude of training opportunities available to vendors seeking to improve their skills.

Finally, the BOSA has inappropriately included vendor 29
non-responses to its questionnaire as an indicator that the department’s efforts for ongoing training are limited. (Note: The BOSA report indicated 64% of the vendors did not respond, however, this was later revised to 50% by the Audit Principal in a telephone conversation in which she indicated 22% were left blank and 28% were marked “not applicable,” “no” or “none.”) This is a faulty assumption based on no specific evidence or support, but merely speculation on the part of the auditors. Appendix B of the report shows that 27.4% of the vendors responded affirmatively to the question “(d)id you find the ongoing training provided by the department helpful?”, while only 8.5% (or ten vendors) responded negatively to this question. The BOSA cited three of these ten responses in its report, however,
the responses do not necessarily support the BOSA’s claim 30
that the vendor was dissatisfied. The first response

suggested courses which are part of the initial training program available to all vendors; the second response indicated the vendor obtained training from outside sources, as should be expected of independent business persons; and the last response indicated the vendor was reluctant to travel during the week for training. These examples do not support the dissatisfaction by vendors portrayed by the auditors in its report.

The Department Needs To Emphasize Consulting Services (page 2-3)

The department disagrees with this finding. Consulting 31
services are to be provided by the department, but given other program priorities, such as equipment control and accountability, the department believes the consulting role of the BEC must be in balance with other job duties.

Consulting services are not a low priority for the BECs, but one of many priorities that the BECs juggle on a daily basis. The auditors stated to the department many times during the exit interview that "a balance needed to be struck" regarding the services provided by the BECs. However, they have given no indication where they feel this
balance is achieved. Instead the BOSA findings conclude 31
that the BECs should do more work on all fronts. The appropriate balance of duties is currently achieved by the BECs based on the established priorities of the program. Furthermore, the BOSA has not supported its position that the balance currently achieved by the BECs is inappropriate because the auditors neglected to adequately evaluate the priorities set by the department in its assessment of the BECs duties.

Moreover, this finding is not supported by the survey of 32
vendors, Appendix B, which shows that nearly 60% of the vendors who responded to the BOSA questionnaire indicated the services provided by the BECs met their needs.

Review of Vendor Profit and Loss Statements (page 2-4)

The department disagrees with this finding, in which the 33
BOSA states that the effectiveness of advice given to vendors by the BECs is questionable because the BECs do not receive the P&Ls quickly enough to respond to problems. Profit and Loss statements, like most financial statements, are prepared in arrears. For instance, the May

P&L is due on June 25th to the department's Accounting section, and those received on a timely basis are forwarded to the BEP two weeks after that date. Therefore, the BECs may not receive May's P&L before July 15. P&Ls are viewed on a monthly basis and as patterns emerge the BECs consult with their vendors. Moreover, the BECs do not rely solely on the P&L report to provide advice and assistance to vendors. Site visits, vendor calls, and building management input offer additional means of responding to potential vendor problems. Nonetheless, the department is in the process of revising the P&L statement procedures to make them less cumbersome, as is addressed hereinafter.

The BOSA also noted the department "must ensure that vendors are maintaining accurate records so that the BECs can verify and rely on the data on the P&L." The BOSA cited internal department audits of four vendors who were unable to provide supporting documentation for their cost of goods sold.

The department disagrees with BOSA's extrapolation of the 34
results of four internal audits as indicative of inefficient record keeping on the part of all vendors. As noted hereinafter, two of the four audits were performed based upon a suspicion that a problem existed, rather than on a random basis. Moreover, to ensure the accuracy of data on every profit and loss statement submitted by vendors as implied by the BOSA in unreasonable. Even on a sampling basis, the department cannot ensure that vendors are maintaining accurate records any more than the Internal Revenue Service can ensure that all tax returns are supported by accurate records. Although the BECs urge their vendors to maintain such documentation, not all vendors heed the advice of their BECs.

The BOSA also stated that not all BECs use the expense guidelines established by the department, but instead use
information presented in the Keating report. The Keating 35
report (a study of the BEP) and the Procedures Manual guidelines are similar in most instances and both are merely guidelines to assist the BECs in their review of P&Ls. The Procedures Manual guidelines were developed many years ago and no documentation is available on how they were developed. The department is incorporating much of the Procedures Manual into Regulations, and has set a high priority on updating the guidelines during this process.

Vendor Appraisals and Reviews of Locations (page 2-5)

The department agrees, in part, with this finding. In this finding the BOSA notes that the BECs do not always complete vendor appraisals and reviews which means they are not maximizing their opportunities to offer consulting services to vendors.

Although vendor appraisals and location reviews may not have been written for every vendor, the BECs provide verbal feedback to vendors on an ongoing basis. While the BEP agrees these appraisals are valuable to the program and the vendors, it has not strictly enforced them in the past, based primarily on more urgent program priorities and daily workload demands.

The BOSA also noted that vendor appraisals prepared by the BECs may not reflect information that has been provided to a BEC from various sources, which may indicate that the appraisal is inaccurate. The department does not 36
agree with this finding. The BECs prepare vendor appraisals based on the most reliable information available. There may be instances when a BEC reviews conflicting information and, as a result, must prepare the appraisal based on his/her independent evaluation of that vendor.

To support its finding that consulting services offered to vendors by the BECs are lacking, the BOSA states that approximately 39 percent of the vendors responding to its questionnaire stated that BEC consulting services did not meet their needs. Although it may not have suited the BOSA's need to support this finding, the same survey 32
response shows that nearly 60 percent of the responding vendors felt that services offered by their BEC do meet their needs. While the department ideally would like to see 100 percent satisfaction rating from vendors in every category, it is unrealistic to expect that every vendor will approve of his or her BEC for a variety of reasons, some of which may not be business related.

The Department's Equipment Policy Limits the Time Available for Consulting Services (page 2-7)

The department disagrees with this finding because the 31
department's emphasis on unaccounted for equipment is appropriate given past problems of unaccounted equipment which have plagued BEP.

The BOSA supports its finding that excessive time is spent on equipment issues rather than on more valuable consulting services by referring to the BEC duty statement 31 prepared by the department, indicating that the BECs should spend approximately 30 percent of their time on equipment services. The BOSA ignores this same duty statement that states the BECs also spend 30 percent of their time on consulting services. The remainder of the BECs' duties include evaluations, paperwork and administrative functions. The BOSA has inaccurately and unfairly portrayed the responsibilities of the BEC based on unsupported and subjective opinion of the relative value of the BEC's functions.

The department has set a high priority on equipment control, accountability, maintenance and purchasing. These duties are not emphasized to the exclusion of consulting services to their vendors. Without proper equipment in a food service location, however, vendors would be unable to effectively operate their business and consulting becomes a moot point.

As stated earlier, the auditors reported several times to the department that they believe a "balance needs to be struck" regarding the duties of the BEC. The BOSA acknowledged that this balance could be individualized given the service area and vendors assigned to each BEC. The 37 BOSA reported that two BECs indicated approximately 50 to 60 percent of their time is spent on equipment-related tasks, but it failed to report whether the individual circumstances of the BEC warranted a higher percentage of time devoted to these tasks to keep vending facilities operational.

The auditors also reported that "while each of the BECs performs the same equipment services, the time involved in providing these services varies by BEC. Consequently, vendors throughout the State may not receive comparable services because the amount of time spent on consulting services varies by BEC." The auditors' implication that all 37 BECs should apportion their time to ensure that vendors receive exactly the same number of consulting hours each month is ludicrous. The very nature of the services provided by the BECs, the changing needs of the vendors, and the emergencies which arise in food service operations prohibit this unrealistic and impractical approach to managing BEC services.

Furthermore, the quotations from vendors included in the 38 report do not provide support to the BOSA's conclusions regarding an improper balance of BEC duties. In an environment of finite resources, it is expected that some vendors would prefer additional attention. In addition, only two of the five cited quotations actually address the issue of redirection of duties. The remaining three simply make suggestions to improve the equipment procurement process.

This finding is further undermined by the contradictory 32
evidence in Appendix B of the report which clearly demonstrates that most of the vendors are satisfied with the services provided by their BEC. The BOSA has reported a finding which is inadequately supported and contradicted by other evidence in its possession.

The Department Needs to Provide Sufficient Guidance to the BECs (page 2-8)

The department disagrees with this finding, in which the BOSA states that the department does not provide guidance to the BECs for them to be effective, and this lack of guidance may result in inconsistent treatment of vendors.

Guidance is provided to the BECs through statutes, regulations, and procedures developed specifically for the program. In addition, they receive ongoing support from their 39
Supervising Business Enterprise Consultants. The BOSA finding places excessive and subjective value upon consistent treatment, when treatment of vendors must reflect each vendor's unique situation.

The BOSA also notes that the department does not have a formal training program for the BECs to teach them how to effectively use management tools, nor does it schedule routine meetings for the BECs to discuss department policy or program administration.

While it is true there is no prescribed, formal training program for the BECs, all BECs meet the minimum qualifications to do their job at the time they are hired, and each 40
BEC has a supervisor who is capable and competent to provide instruction on department management tools. Training for all employees has been limited because of funding shortfalls, and the priority given to client services. During the period audited, all available resources were being used to provide services to our consumers, training was being approved on a "job-required" basis only, and statewide meetings were rarely approved.

The Department's Administration of Program Finances Needs Improvement

The Department Needs to Improve Its Management of Missing Profit & Loss Reports (page 3-2)

The department agrees with this finding, but it does take issue with one of the specific findings.

The department has been reviewing the entire profit and loss (P&L) statement procedure and has already determined that the P&L form is too complex and the process too cumbersome. Therefore, the department plans to simplify the procedures by separating accounts receivable payments from the process. The Business Enterprise Financial System will be modified to track P&L statements and automated accounts receivable billings, recording of receipts, and issuance of delinquent notices. Simplifying the form and maintaining adjustments and loans as separate accounts receivable will provide information more rapidly to the BECs. Training of the BECs and vendors on the new P&L statement procedures will emphasize proper completion, importance of timely submittal, and consequences of delinquency.

The BOSA states the "the department does not estimate fees and penalties for missing P&Ls as required by state regulations..." The BOSA has misconstrued the applicable regulation. (41) California Code of Regulations, Title 9, Section 7221(a) states in part "(w)hen a vendor's financial report is delinquent for more than a month, BEP shall determine the charge based on the most reliable information available." To merely estimate an amount does not meet the standard imposed by the regulation. To accurately determine the charge for missing P&Ls, as required by regulation, requires a tremendous amount of staff time. Prior to investing staff resources into estimating fees and establishing an accounts receivable that will obviously require subsequent adjustment, the department will focus on enforcing the receipt of the P&L statements.

The Department's Monitoring of Accounts Receivable Needs Improvement (page 3-4)

The department agrees with this finding. The BOSA states that "(t)he department does not ensure that it collects all fees due from vendors," and it cites two examples of vendors who filed bankruptcy. Although the examples cited are extreme, the department should have taken more timely action.

Of the more than $2 million in fees which are to be collected annually by the department, less than 5% result in accounts receivables. The BOSA selectively tested current accounts receivable amounts which would generally include two types, those which have recently been developed, and long-standing problem receivables. Two of the instances cited by the BOSA were of the second type, one of which was accumulated from 1991 to 1993 and remained a receivable due to continuing collection efforts. The department, as addressed previously, will modify its mainframe system to improve tracking and collections of P&Ls, as well as enhance the accounts receivable process. 42

The Department Does Not Promptly Identify Need for Corrective Action (page 3-6)

The department agrees with this finding. In its relationship with vendors as independent business operators, the department has not taken swift action when a vendor begins falling behind in his/her payments. A plan of action will be developed to begin addressing vendors who are not fulfilling their obligations to the program.

The Department Has Not Adequately Managed Initial Stock Loans (page 3-9)

The department disagrees, in part, with this finding. The BOSA incorrectly reported that the department is deficient in administering initial stock loan procedures outlined in state regulations and in its procedures manual. According to the BOSA, 39 percent ($90,000) of the total loans outstanding have been deemed uncollectible. In addition, BOSA states the department does not enforce prompt repayment of initial stock loans. 43

Although the BOSA identified what appears to be large losses in loans, the $90,000 identified by the BOSA includes loans made to vendors over a nine year period that were processed for collection and release of accountability in 1996. The amount of uncollectible loans should have been evaluated against the total loans given to vendors over the period of the uncollectible loans. Due to the short response time provided by the BOSA, the department was unable to retrieve exact figures for the nine-year period. However, the department estimates that (43) it may have provided as much as $1,593,000 (assuming an average of $177,000 per year typically loaned to vendors multiplied by nine years) in loans during the period. Based on this comparison, the uncollectible loans for this period would represent only 5.6 percent of this amount, rather than the 39% reported by the BOSA.

Furthermore, the department has analyzed the loans provided to vendors in the 1994/95 through 1996/97 Fiscal Years, and found the following:

- 94/95 Fiscal Year - The department made loans to vendors totaling $161,355. The vendors have repaid 98 percent of the loan amount and 2 percent are 90 days or more delinquent.

- 95/96 Fiscal Year - The department made loans to vendors totaling $244,848. The vendors have repaid 83 percent of the loan amount and 17 percent are 90 days or more delinquent.

- 96/97 Fiscal Year - The department made loans to vendors totaling $124,285. The vendors have repaid 30 percent of the loan amount and 5 percent are 90 days or more delinquent. The repayment percentage is reasonable given the fact over half of the loans were given in the last four months of the fiscal year (March through June 1997) and the analysis was based on collections as of May 30, 1997.

These statistics contradict the BOSA's characterization of (43) a "severe problem with delinquent and uncollectible loan repayments." The auditors performed insufficient and invalid analysis of the initial stock loans in the preparation of this finding.

The BOSA further reported that state law and the department's procedures manual allow the department to grant initial stock loans using set-aside fees to existing vendors assigned to a new location. Because federal law does not permit the use of set-aside fees for loans, the auditors concluded the department should not have made these loans at all.

The auditors are correct that there are inconsistencies (44) between federal law and state law. As is discussed hereinafter, however, the BOSA report is inconsistent in its evaluation of the department's actions in instances where federal and state law conflict.

The BOSA reported the department is inconsistent in applying loan repayment terms to vendors. The department's procedures manual sets forth loan repayment terms. The department agrees that repayment terms have not always been applied in accordance with these internal procedures.

The BOSA reported that the department does not charge penalties on delinquent loan payments as required by state regulations. The department agrees with this finding and will assess penalties for delinquent loan payments.

Finally, the BOSA reported the department does not charge interest on loans as provided in the procedures
manual at 3 percent interest rate. The department does 45
not charge interest on stock loans because there is no authority in regulation that permits it.

The Department's Administration of Set-Aside Fees Needs Improvement (page 3-11)

The department disagrees with this finding. The BOSA reported that certain vendors do not pay their fair share of set-aside fees because the department's monitoring is ineffective. The auditors refer to the lack of control processes in the review of P&Ls (Detailed responses to issues related to P&L processes are included in other sections of this response and are not repeated here) as support for this statement. The BOSA also refers to four of the audits performed by the department's internal audit unit in the last two fiscal years which reported that all four vendors were unable to provide supporting documentation for their cost of goods sold.

The BOSA's conclusion is based on extrapolation of the 34
results of the four internal audits to the remaining population of vendors. Such extrapolation is particularly inappropriate given that two of the four audits were conducted by program staff based on suspected problems, such that any extrapolation from the results of these audits to the general population would be grossly skewed.

The department agrees with BOSA that the original documentation which was used to establish the fee schedule eighteen years ago could not be located in the department's files. In addition, no subsequent analysis was completed. However, the department does not believe that the current fee schedule is unreasonable. Moreover, the BOSA issued a financial report on the program in August 1995 which concluded that the financial condition of the BEP was sound. There have been no significant changes in the financial condition of the program since the BOSA financial report was issued. 46

The BOSA also reported that state regulations require the fee schedule to be adjusted as necessary to allow for program maintenance and growth. State law requires that the $1,000 minimum income, on which the vendors pay a fee, be adjusted annually to reflect changes in the cost of living. The auditors reported the fee schedule was adjusted only once, in 1992, when it increased the minimum amount on which vendors must pay a fee. The auditors suggest that this adjustment was only made to bring the department into compliance with state law. The auditors claim that "(b)y not consistently reevaluating the reasonableness of the set-aside fee schedule and adjusting it as necessary to reflect changes in the cost of living, the department is not maximizing the collection of fees and the federal matching potential. This in turn restricts program maintenance and growth."

The department disagrees with this finding because the viability of the fund is not in question as evidenced by the current fund balance and the BOSA financial report on the program dated August 1995. The auditors have not supported their assertion that program maintenance and growth have been restricted due to the lack of adjustments to the fee schedule. (Note: The set-aside fund, which provides for program growth and maintenance, cannot be used to provide administrative support to the BEP.) 46

The BOSA also reported that the department was unable to provide an analysis that demonstrates the current fee schedule is equitable. In addition, the auditors have concluded the fee schedule is indeed inequitable because of the use of a minimum profit level and an adjustable percentage based on profit (9 percent to 48.6 percent was quoted in the report). The BOSA argues the fee schedule as it is currently structured restricts equal access to the department's services. They further suggest "(t)o ensure that all vendors pay an equitable amount into the fund from which they receive services, the department should propose changes to the state law that established the $1,000 minimum. Also, the department should modify its current fee schedule to ensure all vendors are paying a fair amount of fees. One possible modification would be to establish a flat rate fee schedule as currently used by the business enterprise programs in Florida and Illinois."

Although the report includes several examples as proof of 47
inequities, the auditors fail to adequately demonstrate that the minimum profit amount and adjustable rate are inequitable. The structure of the fee schedule is similar to progressive federal and state personal income tax rates. Minimum levels and adjustable rates are designed to lessen the burden on those individuals whose earnings marginally provide for living expenses and increase the burden on those individuals whose earnings are more than adequate to cover these expenses. The BOSA's finding is equivalent to a philosophical debate on the relative merits of progressive tax versus flat tax. The BOSA's opinion of an appropriate fee schedule is not sufficient evidence of inequity in the current fee schedule.

The BOSA reported that the department is not using the set-aside fees in accordance with federal law. Specifically, state regulations approved by the federal Rehabilitation Services Administration (RSA), authorize the use of set-aside fees for construction of new vending facilities and loans to vendors for initial stock. However, the federal law does not allow set-aside fees to be used for these purposes. The BOSA has indicated in its report that RSA incorrectly approved the state regulations and they plan to rescind its approval of these regulations.

The auditors claim that the loans made to vendors results in less money to assist vendors and to obtain federal matching dollars, thereby restricting program maintenance and growth. The department disagrees with the
BOSA's position on this issue, since the balance of the 46
fund to assist vendors and obtain federal matching dollars was \$3.9 million as of April 1997. The BOSA offers no analysis of what a more appropriate fund balance amount should be. It is unclear whether the auditors feel \$3.9 million is insufficient. The auditors have not supported their assertion that program maintenance and growth has been restricted due to the use of set-aside funds for loans and construction.

This finding also demonstrates the BOSA's inconsistency in 44
holding the department responsible for compliance in cases of conflicting federal and state regulations. Specifically, the BOSA has reported in several places throughout this report that the department is violating federal regulations by the use of set-aside fees for new construction and initial stock loans, even though these purposes are permitted by state

law and regulation. At the same time, the BOSA has reported in this finding that the department has not met the requirements of state regulations, (CCR, Title 9, Section 7221) to allow for program maintenance and growth, even though this purpose is not provided for in federal regulations (34 CFR, Section 395.9). The BOSA suggests in this finding that the department follow state regulations even though it would presumably violate federal regulations, which is contrary to BOSA’s previous position regarding conflicts between state and federal regulations regarding the use of set-aside fees for new construction and initial stock loans.

The Department Needs to Further Improve Its Efforts To Maximize Vending Machine Commissions (page 3-14)

The department agrees with this finding but believes, as indicated by the title of the finding, that it has improved its collection of vending machine commissions.

The BOSA states in this finding that “(t)he Department is
still not collecting all vending machine commissions owed
to the program in spite of state law and 1995 court order
requiring it to do so” and that the “department has not
fully complied with a court order instructing it to actively
pursue and collect all vending machine income.” The 48
department has fully complied with the court’s order and
actively pursued collection of vending machine income.
The department agrees there is additional income to be
collected and it is continuing its collection efforts.

The department has made substantial progress in establishing vending machine contracts and collecting vending machine income. In calendar year 1994 vending income collected was $243,055. Income collected for calendar year 1996 was $1,523,000.

In 1994 the department had one staff analyst assigned to contract for and collect vending machine income. In an attempt to keep current with this growing workload, the department hired two part-time student assistants and borrowed two analysts part-time from another section to assist the staff analyst in the duties associated with identifying locations, contacting agencies, negotiating and establishing contracts, administering contracts for vending machines, and tracking income collected from all vending machine locations throughout the state.

From 1994 to 1997 the department has made significant progress in identifying and contracting for vending machines. The BOSA cites an audit it conducted in July 1994 that revealed the department had identified approximately 880 vending machines. As of May 1995, the department had 35 contracts in place covering 186 machines. By comparison, as of May 1997, the department has identified 3,267 vending machines, 911 of which are under 185
separate contracts. The BOSA ignores these figures, 49
instead asserting that the number of machines under contract, by percent, has remained essentially the same (23% in 1994 as compared to 28% in 1997). The department believes this is a spurious argument at best, and gives short shrift to the department's efforts.

The BOSA also commented that the department has pur-
sued contracting for vending machine income "slowly." 48
The BOSA finding fails to consider that contracting for vending machines is a complicated and onerous task. The agencies with whom these contracts are negotiated are, in many instances, not sympathetic to the department's mandate. Each contract requires an unusually high degree of staff time and effort before it is completed. This effort, which continues throughout the period of the contract, requires monitoring vendor performance and executing changes during the entire term of the contract. This process includes the following:

> The identification of a contracting opportunity through surveys and calls to each agency.
>
> The analysis of locations as possible vending contract sites, including survey site visits, and subsequent negotiations with current service providers and with on-site agency representatives for the amendment or termination of any existing agreements.
>
> The negotiation with the agency for specifics of the provisions, the costs, the potential returns, and other contract issues of the services to be provided.
>
> The preparation of the bid package according to contract law.
>
> The bid award and subsequent negotiations with the successful bidder for the verification of qualifications, and the scheduling for and provision of services.

In addition, according to the BOSA "(b)y not dedicating additional staff, the department is missing an opportunity to substantially increase contributions to the vendor retirement fund." This comment suggests the department has a limitless supply of staff and resources but has chosen not to assign them to this important function. The (50)
BOSA makes this finding in the absence of a program staffing analysis and, more significantly, without regard to how these additional staff positions will be funded. If the department was able to operate in this "perfect-world audit finding" at least 10 more staff would be assigned to this function without regard to cost or funding. It should be noted, however, that without a change in statute, funding for the additional positions must come from the state general fund.

The BOSA also notes that despite the Court order requiring the department to pursue and collect vending machine income from the California State University (CSU) system, the department has "abandoned any further attempts to collect vending machine commissions from the CSU." The (51)
department has met it obligations to actively pursue vending machine income from the CSU system. It cannot order the CSU system to comply with requirements of the law and has taken all reasonable steps to ensure compliance.

The Use of Vending Machine Commissions Is Inequitable (page 3-18)

The department disagrees with this finding because vending machine commissions used to fund the retirement (52)
plan are used lawfully, equitably, and in accordance with the terms of the plan. The report's criticisms of the department for administering the plan in accordance with its terms are unjustified.

To benefit from vending machine income used to fund the plan, vendors must be enrolled in the retirement plan and contribute at least 3 percent of their net monthly income with their monthly P&L report. This is a plan requirement. Vendors are not entitled to a share of vending machine income when leaving the plan unless they have vested by participating in the plan for five years. This is also a plan requirement. The report concludes that these provisions (52)
are inconsistent with federal and state law and inequitable. The department disagrees.

The contribution requirement was included to encourage vendor contributions since vending machine income alone was not sufficient to fund an adequate retirement benefit. It is a sound and rational policy consistent with many, if not most, retirement plans. While a plan that did not
provide for vendor contributions is possible, there is no 52
inequity in a retirement system that provides for such contributions. Moreover, the report offers no evidence that the required contribution precludes vendor participation in the retirement plan. The plan requires a mandatory 3% contribution based on net income. The required contribution is small; it amounts to $60 for a vendor earning $2,000.

Similarly, the plan vesting provision, that requires five years of participation, is neither unlawful nor inequitable.
The BOSA has incorrectly interpreted federal and state 52
law to require that every vendor receive vending machine income. There is no such requirement. The relevant law provides that vending machine income shall be used only for specified purposes, including to establish retirement or pension plans, if it is so determined by a majority vote of vendors. See 20 United States Code Section 107d-3(c), 34 C.F.R. Section 395.8, and Elf. & Inst. Code Section 19630(d). The law allows for discretion in plan design. The vendors have authorized establishment of a retirement plan and that plan specifically requires vendor participation and five years participation to vest. While the BOSA may dislike these provisions, they are lawful. The two paragraph statement from the federal Rehabilitation Services Administration financial advisor referenced in the BOSA report quotes 34 C.F.R. Section 395.8 and adds only the bare conclusion that vending machine income is to be used for the benefit of all vendors. This document does not state the question it purports to answer, includes no analysis to support its conclusion, and does not support the report's assertion that the plan's participation and vesting provisions are unlawful.

The report also criticizes the department for crediting 53
vendors who participate in the plan, but who have not generated net income in a given month, with vending machine income. This is consistent with the plan that specifically provides that each participant shall make a contribution equal to 3% of compensation, and defines compensation as net income from the operation of the facility. If a vendor has no net income for the month, the plan does not require a contribution.

The Department Does Need to Improve Its Controls Over Program Assets (page 3-20)

The department agrees, in part, with this finding. The BOSA states that "the department has not always maintained adequate control of the equipment purchased for the program" and "(i)t does not promptly reconcile certain equipment inventories to its equipment records."

The department agrees with the first finding regarding the use of vendor equipment by a private food service company in the Legislative Office Building. Steps to collect the income due the program have been taken and the equipment will either be sold to the private food service company or will be removed from the facility.

The department strongly disagrees with the second finding 54
that "(i)t does not promptly reconcile certain equipment inventories to its equipment records."

The State Administrative Manual (S.A.M.), Section 8652, requires "a physical count of all property" to be reconciled "with accounting records at least once every three years."

The department, at the time period covered by the audit, required BEP to perform a physical inventory every six (6) months and report the findings to the Property Management Unit of the Business Services Section (BSS). The BSS reconciled the findings to the automated property records and then to the automated accounting records. The BSS staff participate in the actual physical inventory every two years and reconcile the findings on the automated property records and to the accounting records. This provides yet another level of oversight to the safeguarding of departmental assets.

The timelines for issuance of reports appear in the BSS Deskbook on Property Accountability. This is a guide to staff on what constitutes a report, forms necessary to reconcile records, and management timelines for the completion of the process, etc. Thus the "72 day" timeline cited in the audit is established by the department and is not a state-mandated timeline.

The delays in issuing reports have no material affect on 54
the safeguarding of assets. The inventories and reconciliation to the automated property records and the automated accounting records far exceed the standards set forth in S.A.M.

The BOSA has taken very stringent internal standards that were developed to ensure equipment accountability, found that not all are adhered to within the time frames stated, and then interpreted this as a failure to safeguard assets. This characterization is, at best, unsupported by the facts. It must be noted that all equipment is accounted for and properly documented by the BEP. Moreover, this finding critical of the department's equipment procedures is inconsistent with the earlier finding of the BOSA that the BEC's spend excessive amounts of time on equipment accountability issues. 54

The Department's Decisions Have Put the Vendors and the State at Risk

The Department Has Been Slow to Resolve Problems Related to the Retirement Plan (page 4-1)

The department disagrees. It has acted promptly, with the active participation of vendors, to resolve the tax status of the retirement plan on terms favorable to vendors. It has diligently pursued a determination letter from the Internal Revenue Service (IRS). 55

The report fails to recognize that the IRS, not the department, determines the plan's tax status. While the IRS has been slow to act, the department cannot force it to issue a timely determination.

The Department Needs to Resolve Certain Tax-Status Issues (page 4-2)

The department agrees that the tax status of the plan needs to be resolved. It has recognized this since 1991 when it initiated action to resolve the issue. As noted above, the IRS, not the department, is the agency to decide the issue.

The department disagrees with the implied finding that it should have unilaterally stopped treating the plan as qualified without a final IRS determination. Such action would have denied vendors the benefit of tax deferral and subjected them to current taxes on past contributions. It would also conflict with the vendors' expressed desire that the department continue its efforts with the IRS toward qualified plan status. 56

The primary motivation in establishing a qualified retirement plan was, and continues to be, to allow vendors to accumulate funds during their working years sheltered from current income tax. As noted in the report, the department was initially led to believe that the plan was qualified and that no determination letter was needed from the IRS.

In May 1990 the Department of General Services, acting for the department, was advised by its consultant that he had concerns that the plan did not fit into any of the structures that afforded tax-favored (qualified) status under federal law. (This was the same consultant who had previously advised that submitting the plan to the IRS was unnecessary and that there would be no penalty to vendors or the department if it was not submitted.) In February 1991 department staff initiated steps to obtain outside tax counsel. When the issue was first brought to the attention of this administration in September 1991, the decision was made to resolve the issue. In January 1992 outside counsel submitted a request for a Private Letter Ruling to the IRS in Washington, D.C., regarding the income tax status of the plan. The request specifically asked for expeditious handling.

In September 1992, the department was advised by the IRS in Washington to submit the plan to the local IRS office. Oral statements by IRS representatives gave the department reason to believe that the IRS, given the unique retirement provisions of the Randolph-Sheppard Act, might view its arguments in favor of qualified status favorably. In January 1993 the department's counsel had revised the plan to reflect changes in the tax code and completed the lengthy legal research necessary to support the department's position that the plan should be deemed qualified. In March 1993 the vendors' Policy Committee, which represents all blind vendors and with whom the department is legally required to "actively participate" in major administrative decisions, decided to hire its own attorney to review the revised plan. (The report's statement that the department did not inform all vendors of 57
potential problems until December 1995 is misleading. The department promptly informed the Vendors Policy Committee, which represents all blind vendors, of the possible problems with the plan.)

Besides reviewing the department's changes, the vendors' attorney proposed additional changes that were not received by the department until November 1994. Consideration of these changes was further delayed by the vendors' committee desire to have all vendors vote on the plan revisions and the additional changes proposed by its attorney. Some of the proposed changes were not acceptable to the department. Under federal law, the department's deadline for bringing the plan into compliance with the Tax Reform Act of 1986 and submitting it to the IRS was March 31, 1995. The department did not have sufficient time to resolve the disagreement over the proposed changes. It therefore submitted the revised plan, without the proposed changes, and requested the local IRS office to issue a favorable letter of determination on March 31, 1995. Disagreements regarding the proposed changes could be discussed, and any agreed-to plan amendments be made, after the IRS determination.

On September 14, 1995, the IRS issued a tentative determination that the plan is not a qualified plan and that the relevant Internal Revenue Code section was not satisfied because the plan covers persons who are not the employees of the department. The IRS letter provided in part that unless the department could provide compelling facts to the contrary, the findings would be contained in a proposed adverse determination letter to be issued approximately 30 days from the date of the letter. On October 13, 1995, the department requested the IRS to reconsider its position and issue a favorable determination letter.

On December 18, 1995, the department sent a letter to BEP Retirement Plan Participants/BEP Vendors soliciting their vote on the retirement plan issue. The vote favored having the department continue its effort with the IRS toward qualified plan status. Despite repeated department inquiries regarding the status of its request, the IRS has not issued a final determination letter.

The report implies that the department should have stopped 56
treating the plan as qualified. (It states ". . . despite the potential that tax penalties and interest may have continued to accrue . . . the department has not changed the plan's tax status.") The department disagrees. The statute of limitations limits liability for most past taxes and penalties. What is more important, operation as a nonqualified plan would have denied vendors the benefit of tax deferral in the future and subjected them to current taxes on past contributions from the vending machine trust fund. Moreover, it would have done so without a final determination from the IRS that the plan was unqualified. The department believes that Congress intended vendors'

retirement plans to be treated as qualified plans so that vendors could shelter income from current taxation. It is foolhardy to suggest that the department should have unilaterally denied vendors the benefits of a qualified plan. The decision to pursue a final IRS determination was the proper one.

The Department's Administration of Vendors' Employment Status Raises a Question (page 4-4)

The department disagrees. Its relationship with vendors is not that of employer/employee. Vendors operate their own businesses consistent with the statutes and regulations that govern the Business Enterprise Program. They function as independent business persons, not department employees. As the BEP administrator, the department does exercise some authority over vendors. The nature and extent of this authority does not support the conclusion that vendors are department employees. (The department's 1995 request for determination to the IRS argues that the Internal Revenue Code should be interpreted to permit qualified plan status because of the requirements of the Randolph-Sheppard Act, though vendors are not "employees" of the department for employment tax purposes.) 58

The report is inconsistent in its characterization of the vendors' status. It states there is simply an "issue" regarding vendor status and recognizes that ". . . this particular case was difficult to analyze because of the unique nature of the program, the provisions of the Randolph-Sheppard Act, *and the factors do not weigh heavily in either direction."* It elsewhere states there is a "strong potential that vendors should be classified as employees of the State. . . " 59

The report is also inconsistent regarding "guidance" provided by Federal and State statutes. It incorrectly concludes that "Federal and state statutes do not provide any specific guidance as to whether vendors should be classified as independent contractors or employees of the State." At the same time, it recognizes that the department administers the program according to federal and state law and that to accomplish the purpose of the program, the department provides ". . . training and vending facilities to enable qualified blind persons *to operate their own* vending businesses. .. ." and that " . . . the program is unique within a government setting because it consists of numerous *individual businesses* competing with private- 60 sector entities for profits." It recommends that the department "(i)mplement those modifications that will ensure that vendors are treated as intended." Presumably, the BOSA agrees with the department that Congress and the Legislature intended vendors to be treated as individual business operators. This statutory guidance is reflected in Almond et al. v Boyles et al., 612 F. Supp. 223 (1985) which states that "(t)he Act's language and legislative history indicate that Congress intended for the Randolph-Sheppard vendors to be treated as self-employed independent contractors." (In Almond the State of North Carolina, unlike the department, treated vendors like they were state employees. Since 1971 North Carolina collected the vending stands' gross proceeds, made deductions therefrom, and then distributed the balance to the vendors. Prior to 1971, however, vending stand operators were paid a weekly salary and bonuses. The Court noted that in 1983 the State "finally came to realize that Randolph-Sheppard vendors were properly classified as self-employed individuals rather than state employees.")

While the report finds that the department has put the 61
State at risk through its administration of the program, it relies on numerous factors grounded in law over which the department has no control. The factors that purport to put the State at risk, such as the length of the department-vendor relationship, retirement fund receipt of vending machine commissions, department responsibility for vendor training, establishment of locations, and contracts with building management, are statutory program mandates. The report states the department's right to impose progressive discipline in dealing with vendor problems is "similar to an employment relationship." It ignores the department's legal mandate to license vendors and inexplicably fails to acknowledge that vendors are licensees, not employees.

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The report is inconsistent regarding the issue of department control of vendors. It unjustifiably criticizes the department for exercising "a substantial degree of direction and control over the vendors." As set forth above, the control exercised over the vendors is a result of the statutory responsibility to act as a licensing agency. At the same time the report criticizes the department for not adopting procedures "that compel vendors to adhere to the terms of their contracts with the department. . ." The report also recommends that the department '(m)odify its contracts with the vendors to include ranges of acceptable performance, uniformly enforce the terms of the contracts, and suspend or terminate the licenses of those vendors

who fail to respond to counseling and continue to disregard the contract terms.'" These inconsistencies highlight the (58)
weaknesses in the report's conclusion that vendors are department employees.

The report relies, at least in part, on an opinion from the BOSA's legal counsel. The BOSA has denied the depart- (62)
ment the ability to respond fully and adequately because it has refused to provide counsel's written opinion. (Prior to issuance of the draft report, the supervising auditor permitted department counsel to read the opinion and meet with counsel. The department was subsequently advised by the audit principal that this was done in error and that it would not be provided with a copy, or permitted to read the opinion, in order to respond to the draft.) The department does not know what additional legal advice, if any, was provided, nor can it distinguish the findings of legal counsel from those of the auditors. Moreover, the report does not include legal citations or facts to support a finding that ". . . state regulations contain numerous other instances that provide the department with the ability to exercise control over the vendors."

The report fails to recognize that an individual may be an (63)
employee for some but not all purposes. Employee status depends upon the application of law in each particular situation. The answer may vary depending upon whether the purpose is workers' compensation, unemployment or disability insurance, collective bargaining, retirement benefits, social security, or income tax withholding. See 68 Ops. Cal. Atty. Gen. 194. The report concludes that vendors may be entitled to participate in the public employees' retirement system and the State's deferred compensation program, without any supporting analysis of applicable law. (It is unclear from the report whether this is a conclusion of the auditors or legal counsel.)

The report's paraphrasing of statements by the (64)
department's Chief Counsel is incomplete and inaccurate. Department counsel advised that employee status depends upon the law in each situation and that vendors, as participants in a government-sponsored program,
are unique. It was stated that BEP vendors are indepen- (65)
dent business persons rather than department employees. It was also stated that vendors, as participants in the Business Enterprise Program, were unlike the independent contractors in cases that distinguish between employees and independent contractors in that independent contractors rendered services to, and received compensation from, their customers rather than the

department. (An independent contractor is one who, in rendering services, represents his "employer" only as to the results of his work, and not as to the means whereby it is accomplished. Green v. Soule (1904) 145 C. 96, 99.) Under the Business Enterprise Program, the department provides services to vendors; vendors do not provide services to the department. Since the department does not 66
pay vendors, one wonders how it could be liable, as the report suggests, "for failure to withhold certain statutory taxes from the amounts paid. . . ." This is one of many reasons why a generalized finding that vendors are employees is unjustified.

The report's implication that independent business persons 65
must exist as a category unique from employee or independent contractor misses the point, as does the report's statement that department attorneys have called vendors independent contractors. What is significant is that vendors are independent.

The department does not control the details of the vendor's 67
work. Its standard agreement grants vendors "the right to operate a vending facility." This agreement references the standard agreement with building managers that authorizes the department to establish a vending location. In this agreement the department also agrees to place a vendor "in charge of" the facility. This agreement provides that the vendor shall provide, in addition to food and beverages, other items "approved by the STATE and CONTRACTOR [building management] of good and wholesome quality at reasonable prices. . ." Such provisions address building management's desire to ensure that the vendor fairly serves its employees. General powers of oversight shared by the department and building management are consistent with the department's responsibility as a licensing agency and do not convert the relationship between vendors and the department to that of employer-employee.

The department does not ensure vendors for workers' 67
compensation. Workers' compensation is provided for vendor employees through a self-insurance plan paid for by vendors. The department has purchased an excess liability policy with vendor funds covering vendor employees. It has also purchased with vendor funds a general liability policy covering vendors and the Business Enterprise Program.

The BOSA report concludes a programmatic review and audit of the BEP, pursuant to Welfare and Institutions Code, Section 19640.5. Areas covered by the BOSA audit included a follow-up of the prior financial audit (Year ended June 30, 1994) recommendations, vendor profit and loss (P&L) statements and loan payments, number of vending stands and vendors served, development of new sites, vendor eligibility, vendor training program, use of federal and state funds, and equipment accountability.

The BOSA report is critical of the department in many areas of its management of the program, as is indicated by the title of its report: **Poor Management Practices Limit the Effectiveness of the Business Enterprise Program** 1 **for the Blind.** While the department agrees the program has room for improvement, it takes issue with the title of the report, a significant number of the findings in the report, and the erroneous assumptions and flawed analysis which underlie many of the findings.

The title of the report suggests that the department's management of the BEP is the sole cause of the problems faced by the program. The title also implies that current resources managed more effectively would be adequate to 2 meet the needs of the program. The department disagrees. The Audit Principal acknowledged during the exit conference that the department must "strike a balance" to comply with all program requirements.

To implement all the BOSA recommendations and manage 2 the program at the level suggested by the BOSA in this review would require a staffing ratio unequaled in any traditional state government program. The precise extent to which the staffing would need to be enriched to comply with the BOSA recommendations is uncertain, and the BOSA did not complete a staffing analysis as part of this program review.

The department has also highlighted in this response 1 many instances where the BOSA incorrectly interpreted facts and/or law; performed incomplete analysis; unfairly discounted department improvements, policies and procedures; developed findings based on speculation and subjective opinion rather than factual documentation; and made findings which are inconsistent or in conflict with other findings or information in the report.

The audit also ignores the resource limitations within the department, and the needs of clients of other department services. Currently the department, due to insufficient resources, is unable to serve all eligible VR clients, and has more than 2,000 individuals with disabilities on a waiting list. Every additional dollar or staff person redirected to the BEP is one less available to the general VR program, and likely to increase the number of individuals with disabilities on the waiting list for VR services. 2

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Comments

California State Auditor's Comments on the Response From the Department of Rehabilitation

To provide clarity and perspective, we are commenting on the Department of Rehabilitation's (department) response to our audit report. The numbers correspond to the numbers we have placed in the department's response.

1 Our report points out the need for improvement in many aspects of the department's administration of the program. While the department acknowledges that there are problems within the program, it disagrees with many of the findings and conclusions in our report. In its response, the department has mischaracterized a significant number of the comments we have made as well as the work that we performed to support the report. Our report is fully supported by evidence, and we stand by the information as presented. We are concerned that the department's response to our report indicates that it does not fully recognize the breadth of its problems. Until it does so, the department will not be able to improve the program as needed.

2 In the conclusion to its response, the department contends that implementing the recommendations in our report would require significant additional staff and states that we did not complete a staffing analysis as part of our review. Our role is to determine whether the department is meeting its responsibilities. Staffing analyses should be completed by the department as part of its responsibility to effectively manage resources. Further, it is because of limited resources that we believe it to be imperative that the department fully explore its program operations to ensure that the program runs efficiently and effectively.

3 The department raises a number of concerns regarding the program's place, both in the modern business world and the modern vocational rehabilitation world. The department believes that the program is outmoded, uses a disproportionate share of resources at the expense of other vocational rehabilitation programs, and creates an expectation of

continuing dependency. These issues raised by the department entail significant modifications in federal and state law. Our audit focused on the program's operation as it currently is constituted by law.

④ The department has misunderstood our recommendation. Adequately promoting the program to ensure that blind individuals are made aware of it simply ensures that individuals are informed of all of their options. Additionally, an increased applicant pool would enable the department to have a better opportunity to select applicants that are well-suited to the program. Moreover, our report does not indicate that all "blind people" in California desire a career in food service and if made aware of the program would immediately apply for services as later stated by the department.

⑤ We modified the text to present the comparison using net income per vendor. The comparison we present differs from that discussed by the department in its response because it subsequently provided us with revised information.

⑥ Contrary to the department's statement, we did not support our finding based on one counselor. We considered the overall process by which the department provides program information to its rehabilitation counselors for the blind and other counselors and concluded that the process did not ensure that all are sufficiently informed.

⑦ We did not conclude that the current regulations requiring medical and vocational evaluations are no longer appropriate. We merely present the department's belief that the regulations are no longer appropriate. We do, however, caution the department to ensure that these regulations are not a necessary component in determining an applicant's potential for success in the program before it proposes changes to the regulations.

⑧ The department points to certain locations that it has opened since February 1995 as evidence of its success in location development. The department nevertheless has closed more vending locations than it has opened in recent years, as summarized in our report.

⑨ The department has identified "large, complex locations" as "cafeterias;" however, we do not agree that the larger, more complex locations that we discuss in the report have to be cafeterias. For example, a larger or more complex vending location could be a large vending machine route, multiple facilities operated by one vendor, or could have more varied and innovative products and services, calling for more advanced skills on the part of the vendor. As stated in our report, we believe the department should establish larger, more complex, and _more profitable_ locations. We do not recommend that the department establish undesirable or unprofitable locations.

⑩ Forty percent of vendors responding to our survey answered "no" to the question "do you believe that there are adequate opportunities for upward mobility?" We believe this represents a significant number of vendors dissatisfied with the opportunities for upward mobility and should be of concern to the department.

⑪ The department's argument against our finding seems to be that it does not have the wherewithal to accomplish functions that are required of it, except in a limited manner. It contends that it does not have the resources or expertise required to compete on a level playing field in today's marketplace. Nevertheless, the department still has the responsibility to try to establish more profitable locations, such as popular destinations for the public.

⑫ Contrary to the department's statement, we do not believe that the department should aggressively pursue all locations that could become a program facility. Instead, our report states that the department needs to be more aggressive in location development and should pursue new kinds of places for its vending locations with a view toward present and future profitability.

⑬ The department disagrees that its actions with respect to pursuing Department of Defense facilities were indicative of a lack of initiative in location development. Our report acknowledged the concerns the department had regarding these locations. Nevertheless, as stated in the report, the department decided to devote staff to explore the issues related to the Department of Defense only in response to threatened legal action by the California Vendors Policy Committee.

⑭ Contrary to the department's assertion, we believe, as we state in our report, it does have the regulatory and legal authority to combine locations.

⑮ The department contends that its analysis of the potential coffee cart route determined that it would not be a viable vending facility. When we asked for its analysis, the department summarized reasons why it determined that the facility would not be viable. However, it acknowledged there was no specific documentation supporting its decision. Therefore, we were unable to verify that the department's decision was appropriate.

⑯ We are pleased to see that the department is planning to explore creative solutions such as assigning coffee carts or hot dog carts to existing locations. However, as stated in our report, we believe the department already has the regulatory authority to assign such satellites to existing locations.

⑰ The department takes issue with two examples that we included in the report of instances where the department had not sufficiently documented its analysis of the viability of a potential vending facility. Although the department has provided explanations in its response as to why these locations were not feasible, the department could not provide supporting documentation for the explanations. Thus, we are unable to corroborate the department's conclusions that the potential locations were not feasible. We acknowledge that these locations may in fact have not been profitable opportunities, but we remain concerned that the department does not always sufficiently document its analysis.

⑱ We stated that the report was primarily prepared for the California Vendors Policy Committee (committee) because the section of state law which requires the report provides that the department was to submit its initial report "to the committee of licensed blind vendors and to any appropriate governmental agencies." The section also requires biennial updates to be submitted to the committee and the Legislature and states that the reports are to be used by the department and the committee to develop greater opportunities. Further, we would have concluded that the report was required even if the committee was not the primary recipient of the report because the paperwork reduction act, which the department cited as its reason for not preparing the report, applies only to reports prepared for the Legislature or the governor. This report was to be prepared for the committee as well as the Legislature. Finally, the department misses an important point as the report would be an appropriate vehicle for identifying potential new locations as well as any existing vending facilities operated by other than program vendors, and the department has not shown that it has developed any satisfactory alternatives to accomplish the same ends.

⑲ Based on its own interpretation of our report, the department draws the conclusion that we contradict ourselves. The department decided that "larger, more complex, and more profitable" locations means "cafeterias." Contrary to its interpretation, we use the terms in a much broader sense; a vending location which is supplemented by satellite facilities would naturally be larger and more complex, and it is hoped, more profitable, than the same vending facility unaugmented by satellite locations.

⑳ We are pleased to hear that the department is working on a contract with Los Angeles County that would expand service and product lines. Additionally, the department provided information that shows it has recently increased the number of locations with espresso service. We have added text to clarify this. However, we remain concerned that the department has been slow to investigate or develop new business ideas in general. During our fieldwork, when we asked the department for the status of plans for new ideas under consideration, it acknowledged that the ideas were in the discussion stage.

㉑ The department incorrectly asserts that our report subjectively concludes that the interim location process is not fair. The department contends it makes a "fair and impartial" decision when selecting interim vendors; nevertheless, only certain vendors are considered and the selection decision is discretionary. The department has missed our point that the assigning of interim sites is inequitable because not all vendors have the opportunity to competitively bid for available sites.

We considered the department's settlement agreement with the vendors when we reviewed the interim location process. In fact, the settlement agreement has exacerbated the inequity of the current method of assigning interim sites because it effectively gives vendors operating these sites permanent locations for which no competitive bidding process took place. Further, it is unclear why the department is drafting regulations to address the process for assigning interim locations if it believes the present process is an equitable method.

㉒ The department has clearly misunderstood our listing of the reasons the department might use to classify a site as an interim location. Our report simply presented the department's policies for classifying a location as interim. We do not indicate that the department was negligent for classifying a location as interim for any of these reasons.

(23) Upon review of additional documentation provided by the department, we have modified our text to indicate that, at the time of our review, the department had not circulated six interim locations which have averaged more than $2,000 per month in net income.

(24) The department contends that its policy does not preclude a vendor having a primary and interim location from competing for a different primary location. However, vendors can be excluded from operating a primary site for which they applied and which they were awarded, simply because they are operating another primary site and the department's current policy is to not approve vendors to operate multiple primary locations. We have modified the text to clarify the issue.

(25) The department has incorrectly concluded that this finding contradicts our previous finding. If there were a static number of locations, then allowing vendors to operate multiple sites would indeed decrease the opportunity for other vendors to participate in the program. However, increasing the total number of locations available, as we recommend, would increase the opportunities for other vendors to participate in the program as well as for those already in the program.

(26) On the contrary, we do not discount the value of the initial training program. Further, the department's statement that we contradict ourselves is incorrect. We conclude that the department offers limited ongoing training opportunities, especially for vendors already possessing certification from the National Restaurant Association (NRA). Our report states that the use of the initial training curriculum as ongoing appears reasonable for vendors not having obtained certification from the NRA. However, for those recently licensed vendors already possessing NRA certification, using the initial course as ongoing training would not provide useful training.

(27) While the vendors may have a responsibility to seek out and attend training to enhance their skills, the department has a statutory responsibility to provide ongoing training to all vendors.

(28) The department contends that we implied that classes in tax preparation and new tax laws should be made available to vendors. These classes were suggested by the vendors in response to the question in our survey that asked what types of ongoing training would be most beneficial. Further, the department states that it has no obligation to assist vendors with

the preparation of personal income tax reports. The vendors indicated that training in <u>business</u> taxes would be useful. We have added text to clarify this matter.

29 The department contends that we inappropriately included vendor nonresponses to our questionnaire as an indicator that its efforts for ongoing training are limited. Our question asked the vendors, if they had received ongoing training, to identify the types of training received. We continue to believe that no response or a response of not applicable to this question would be the expected responses if vendors were not receiving ongoing training, especially since these vendors generally responded to the other questions.

30 We believe the responses support our claim that these vendors were not satisfied with the ongoing training offered by the department. The department responded that classes addressing new trends in the food service industry are available in the initial training program. If these classes are available, yet vendors are requesting them, then either the vendors are unaware that the classes exist or the material does not meet their needs. To clarify why one vendor received ongoing training from other sources, we added the remainder of her response: "because she does not believe the training offered by the department would be beneficial to her." The department contends the last response indicated that the vendor was reluctant to travel during the week for training. However, we believe the vendor's response may indicate that classes held during the week are not convenient. As stated in our report, this vendor also responded that he would attend training if he did not have to travel to Sacramento.

31 Contrary to the department's response, we believe that we sufficiently considered the Business Enterprise Consultants' (BECs) priorities. We conclude that the main role of the BEC should be to promote and encourage vendor success and the department's policy of requiring them to be involved in all aspects of providing and maintaining equipment may be an inefficient use of the BECs' time. Our recommendation is that the department re-evaluate the use of the BEC position to provide equipment services with the goal of optimizing the time available for BECs to provide adequate consulting services, not that BECs "do more work on all fronts."

32 As the department points out, Appendix B shows that nearly 60 percent of the vendors responding to our survey believe that the BEC services meet their needs. While the department may feel this is an acceptable percentage, we believe the department should be concerned that approximately 39 percent of the vendors responding do not believe BEC services meet their

needs. Moreover, we liberally interpreted certain vendor responses to the department's benefit when "Yes" responses were qualified with additional concerns or comments.

33 We disagree with the department's assessment of the timeliness of receiving profit and loss statements (P&Ls). The department indicates that BECs may receive P&Ls approximately six weeks after the close of the reporting month. If the BECs actually received the P&Ls within six weeks, the review would be more effective. However, as noted in the report, the P&Ls are usually received two to three months after the close of the reporting month. Further, the BECs we interviewed indicate that the lateness of the reporting makes it very difficult to respond in a timely manner to any problems they may detect in their review of P&Ls.

34 The department has misinterpreted our reference to the results of the four internal audits. These references are presented to illustrate the effects of insufficient monitoring of the accuracy of P&L data, not to extrapolate a conclusion as the department suggests. The department has clearly missed the more important issue. If the accuracy of the P&L data is unverifiable, the department cannot ensure that BECs correctly identify problems that may exist or that vendors are paying the correct amount of fees because they cannot verify the reported information.

35 The department has minimized the importance of using consistent guidelines. While the guidelines in the procedures manual and in the Keating report may be similar in some instances, certainly a 32 percentage point difference in costs of goods sold in the Los Angeles area ought to raise a concern about consistency in the use of these guidelines.

36 We agree that the BECs should prepare vendor appraisals based on the most reliable information available. However, the financial information for the two vendors mentioned in our report who were delinquent in loan repayments and set-aside fees was maintained within the department's accounting section. As stated in our report, in the other instances, the same BEC who rated a vendor's sanitation and safety as very good wrote a letter the very next day that described actions that would be or had been taken to address sanitation issues occurring at the facility. The timing of the letter clearly indicates that these conditions existed at the time of the appraisal, yet the appraisal makes no mention of them.

(37) We acknowledge that individual circumstances of vendors may sometimes warrant a higher percentage of BEC time devoted to equipment services. However, we remain concerned that the significant amount of time spent on equipment services reduces the time available for consulting services. Further, as our report states, the department's duty statement indicates that BECs should spend approximately 30 percent of their time on equipment services. Contrary to the department's response, we do not imply that BECs should apportion their time to ensure that vendors receive exactly the same number of consulting hours each month.

(38) Our conclusion is based on our analyses of the duties and responsibilities of the BECs. The vendors' comments are consistent with our analyses and reflect the department's policy of requiring BECs to be involved in all aspects of providing and maintaining equipment.

(39) We disagree with the department's assertion that we place excessive and subjective value upon consistent treatment of vendors. We recognize that vendors' situations may be unique; however, we do not believe this precludes the department from maintaining policies to ensure that vendors are consistently treated.

(40) We acknowledge that supervisors provide instruction to the BECs; however, formal training for the BECs is also needed. As stated in our report, some BECs have received little or no training within the past two years.

(41) We are pleased the department has decided to review the P&L procedure and plans to make improvements. However, we disagree with the department's statement that we have misconstrued the regulation requiring the department to "determine the charge based on the most reliable information available" because we stated that the regulation required the department to estimate fees and penalties. The department states that "estimating" the charges is not the same as determining the charges based on most reliable information available and that accurately determining the charge for missing P&Ls, as it believes is required by the regulation, requires a tremendous amount of staff time. In the absence of actual data, the amount determined by the department would necessarily be an estimate. Further, we do not believe it is appropriate for the department to ignore a state regulation because it finds the regulation too burdensome.

(42) The department points out that we selectively tested accounts receivable. It is appropriate for us to use judgment in selecting items to test when performing a review of this nature.

43 The department's contention that we performed an insufficient and invalid analysis of initial stock loans is incorrect. Our report points out that the department had a significant amount of delinquent and uncollectible initial stock loans at the time of our review. The department misses the point when it attempts to estimate uncollectible and repayment rates over extended periods of time.

Also, we note that according to the department, it has granted an estimated $1.6 million in loans over the past nine years despite the fact that according to federal law, set-aside fees may not be used for initial stock loans.

44 The department contends our report is inconsistent in its evaluation of the department's actions where federal and state law or regulations conflict on the use of set-aside fees. However, the department clearly misunderstands our findings and recommendations on the appropriate use of set-aside fees. We do indeed encourage the department to follow the state requirement to use set-aside fees to ensure program maintenance and growth. However, this in no way contradicts federal law. The allowed uses specified in the federal regulations are for the general purpose of maintenance and growth of the program. We took issue with two specific uses, initial stock loans and new construction, which are allowed by the state regulations but not the federal law or regulations.

45 The department states it has no regulatory authority permitting it to charge interest on initial stock loans. However, as we state in our report, although regulations do not specifically state that the department can charge interest, we do not see that the department is precluded from doing so.

46 The department mistakenly indicates that we question the fund's viability per se. The question is not whether a $3.9 million trust fund is adequate, but rather whether the department is maximizing the collection of fees. By maximizing the collection of fees, the department can ensure program maintenance and growth. Additionally, to state that there have been no significant changes in the financial condition of the program since our financial audit does not sufficiently address whether the fee structure is reasonable because it does not address the allocation of fee charges to vendors. In the absence

of an analysis supporting the reasonableness of the fee schedule, we continue to conclude that the department has not demonstrated that it administers set-aside fees in a manner equitable to all vendors.

47 The department is incorrect in assuming that this is only a philosophical debate. The department provided no analysis to show that this fee schedule was a reasonable or an equitable method for collecting fees. In addition, the significant disparity in the percentages charged, in itself, suggests an unequal treatment of vendors. Further, it is hardly only a philosophical debate when records indicate that a significant number of locations have vendors that are receiving benefits from the set-aside fund even though they did not contribute to the fund each month.

48 We disagree with the department's position that it has fully complied with the court order and actively pursued collection of vending machine commissions. We recognize that, for some agencies, the contracting process can be complicated. However, we found that the department has been slow in pursuing the collection of vending machine commissions. As stated in our report, almost 22 months after the interim order was issued, the department has not yet contacted all of the affected agencies to initiate the contracting process, including 19 of the National Guard facilities or any of the Department of Parks and Recreation concessions.

49 The department's statement that we have ignored the May 1997 figures is misleading. Our fieldwork focused on information as of January 31, 1997. Our report properly presents the information pertaining to the number of vending machines identified and the contracts established as of that date. Contrary to the department's response, we do not assert in our report that the number of machines under contract, by percent, has remained essentially the same.

50 The department ignores our recommendation to perform an analysis to determine the costs and benefits of using moneys in the trust fund to address staffing needs.

51 We do not agree with the department's position that it has met its obligations to actively pursue vending machine commissions from the California State University (CSU) system. As stated in our report, the CSU represents a lucrative opportunity for the vendors and the department should comply with the court order and pursue these commissions to ensure that it is acting in the vendors' best interest.

52 The department has mischaracterized the conclusions that we present in our report. We conclude that the department's use of unassigned vending machine commissions for the retirement plan is inequitable because it does not benefit all vendors as required. To ensure that we properly interpreted federal regulations, we requested written clarification from the federal Rehabilitation Services Administration. As we state in our report, the federal Rehabilitation Services Administration comments that the language used in the federal regulations means unassigned vending machine commissions are to be used for the benefit of all vendors. Although the department contends that the report offers no evidence that the required contribution precludes vendor participation in the retirement program, we believe that only the vendors know what level of contribution precludes them from participating in the plan. Thus, this is not addressed in the report. However, we report the results of our testing which support our conclusion that certain vendors who would most need a retirement plan, such as those with low incomes, are not receiving benefit from the unassigned commissions.

53 The department contends that if a vendor has no net income for the month, the plan does not require a contribution. However, the retirement plan has no provision for this type of situation, and the department was unable to provide any documentation that the retirement plan authorized this arrangement.

54 Contrary to the department's assertions, we believe that it is appropriate to test the department's records against its own standards for reconciliation of equipment inventory. The department's failure to meet its own standards 36 percent of the time clearly indicates that it needs to improve its controls. Further, our report did not conclude that the delays in issuing reports had a material effect on the safeguarding of assets as the department indicates. Finally, the department's statement that this finding is inconsistent with an earlier finding that BECs spend excessive amounts of time on equipment accountability issues is incorrect. The department's need to emphasize consulting services should be balanced within the BECs' workload along with equipment inventory responsibilities.

55 We disagree with the department's contention that it has acted promptly to resolve the tax status of the retirement plan. As we state in our report, more than seven years has passed since the department was first informed of the plan's tax status problems, yet the issues remain unresolved. Within that seven-year period

was a delay of nearly three years between the date that the department was notified that the Internal Revenue Service (IRS) Washington D.C. office declined to make a ruling because the issues submitted were not under its jurisdiction and the date that the department submitted the plan to the IRS office that had jurisdiction.

Additionally, the department contends that it cannot force the IRS to issue a timely determination. Although we recognize that the department has made certain efforts to follow up with the IRS since it resubmitted the plan, it is not clear that the department has done all that it could to ensure that the matter was promptly resolved. Because of the potential liability involved, we believe the department needs to increase its efforts to ensure that the retirement plan issues are resolved as quickly as possible.

56 The department contends that our report implies that it should have stopped treating the plan as qualified. We did not recommend this in our report. Instead, we recommend that the department work to resolve the retirement plan issues as quickly as possible. However, to clarify this matter further, we modified the sentence about which the department expressed concern. Further, although the department states that the statute of limitations limits liability for most past taxes and penalties, it is unknown how limited the liability would actually be. Thus, it is crucial that the retirement plan issues be resolved soon.

57 Based on additional documentation that the department submitted to us regarding the notification of vendors, we deleted text.

58 The department mischaracterizes our report as concluding that vendors are employees. The report does not reach that conclusion. Instead, it discusses the potential for a reviewing agency or court to determine that the vendors are employees under the present relationship and recommends that the department implement modifications that will ensure that vendors are treated as intended.

Additionally, while the department dismisses the potential for a finding of an employment relationship, it ignores that its right to control the operation of the vendors, and the actual control of the vendors, conflicts with its characterization of the vendors as independent businesspersons. The department has the authority to exercise certain control over, among other things, prices of merchandise sold, the type of merchandise sold, and the replacement and maintenance of the equipment purchased for the vendors.

59 Contrary to the department's claim, the report is not inconsistent in its characterization of the vendors' status. This issue, which is a major one, involves the balancing of several factors as discussed in the report. Were that balancing test conclusive, there would be no need for the lengthy consideration of the independent contractor/employee issue. However, because that balance does not weigh conclusively in either direction, several factors must be examined. (To clarify this matter, we have replaced the word "heavily" with the word "conclusively" in the text.) As discussed in the report, that examination indicates a strong potential that a reviewing agency or court could determine that vendors are employees. It is that issue which the report recommends be addressed to avoid the potential future problem of an employee classification.

60 The department is also incorrect in stating that we are inconsistent regarding guidance provided by federal and state statutes. As stated in the report, federal and state statutes do not provide any specific guidance whether vendors should be classified as independent contractors or employees. If the statutes did so, the analysis would be based on that guidance. Instead, the independent contractor/employee question is determined by common law.

The department also raises the *Almond vs. Boyles* (*Almond*) case in which the court stated that the language and legislative history of the Randolph-Sheppard Act indicate that Congress intended the vendors to be treated as self-employed independent contractors. However, according to our legal counsel, congressional intent does not alter the several factors in the department's relationship with its vendors which tip the balance in favor of an employer/employee relationship. Further, the facts of the *Almond* case related to North Carolina's vendor retirement plan and have no relationship to the administration or tax treatment of California's plan. *Almond* is factually inapplicable to California's situation because it dealt with North Carolina's refusal to recognize the vendors' vote not to participate in the state-administered retirement plan and to provide a refund of prior contributions. California's situation does not deal with a vendor/state dispute, but instead the specifics of the relationship between the department and the vendors which could lead to a conclusion that the vendors are employees.

61 The department contends that it relies on numerous factors grounded in law over which the department has no control. Additionally, the department argues that the report ignores that

the vendors are licensees. However, these arguments in themselves ignore the substantial right and amount of control the program exercises over the vendors. That control extends beyond the program's statutory authority. It is this type of control which raises the potential for a determination that the vendors are employees.

The department also states that the report is inconsistent regarding the issue of department control of vendors because the report recommends that the department modify its contracts with the vendors to include ranges of acceptable performance and uniformly enforce the terms of the contracts. On the contrary, the recommended modifications are designed to eliminate the control problems which presently exist in the program's relationship with the vendors. The contract between a principal and independent contractor sets forth the parameters of the relationship. The parties agree that the contractor will reach the stated results. It is through modifications to the contract, and requiring the vendors to adhere to its terms, that the department can require the vendor to meet the requirements of the program without exercising excessive control.

62 The department's statement that we have denied it the ability to respond fully and adequately because we have refused to provide the written opinion of our legal counsel is misleading. We believe we have provided the department sufficient opportunity to understand the basis for the conclusions presented in the report. We, along with our legal counsel, met with the department specifically to discuss the conclusions reached in the opinion as well as the basis for the opinion. Additionally, the department was provided the opportunity to contact our legal counsel directly to discuss any additional questions it had; however, the department chose not to do so. Further, although the department is correct that the state regulations referenced in the report are not cited specifically, the information was discussed at the meeting with the department.

63 The department's argument that an individual may be an employee for different purposes (e.g., workers' compensation, unemployment insurance, social security, etc.) ignores that various agencies use essentially the same common law factors as those discussed in the report. Based upon the specific facts of the department's relationship with the vendors, the potential exists for the vendors to be characterized as state employees under a variety of circumstances. One such circumstance, if they were determined to be state employees for retirement purposes, is that they would be eligible to participate in the Public Employees' Retirement System.

64 To address the department's chief counsel's concern that we did not paraphrase him correctly, we have modified the text.

65 The department's characterization of the vendors as independent businesspersons poses a problem because, according to our legal counsel, there is no legally recognized classification as an independent businessperson. Individuals are either employees or independent contractors. A business operation may be characterized as a sole proprietorship, a partnership, a corporation, etc. An independent businessperson is not within either the individual or the business classification.

66 While it is true that the department does not pay wages directly to the vendors, it does make contributions to their retirement program. Further, according to our legal counsel, an agency or court conclusion that the vendors are employees could result in revenue to the vendors being characterized as wages for withholding tax purposes. Thus, revenue earned by the vendors through their vending stands could be characterized as wages from which withholding taxes should have been paid.

67 The department states that it does not control the details of the vendor's work, and it stresses the significance of the independence of the vendors. As detailed in our report, that independence is illusory in many cases due to the department's right to exercise, and actual exercise of, control over the vendors. The facts of that relationship are more than the general oversight that the department contends that it provides. In many respects, the department controls the details of the vendors' operations. In some cases, that control is specifically provided in the contracts with the vendors and the building operators.

Purchase of insurance is one example of that control. The contracts require the vendors to participate in the master insurance policy. As discussed in the report, while "vendor funds" are used to purchase the insurance, not all vendors presently pay for that coverage because the department does not enforce the payment requirements. Thus, some vendors receive insurance coverage without paying. This arrangement is contrary to the department's premise that each vendor is an independent businessperson.

cc: Members of the Legislature
Office of the Lieutenant Governor
Attorney General
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps