

Assembly Committee on Accountability and Administrative Review

Rebates and Transparency in Public K-12 and Higher Education Food Service Contracts

BACKGROUND

At a time of painful budget cuts throughout public education, food service companies are collecting potentially millions of dollars a year in off-invoice rebates from national suppliers through contracts with California schools, community colleges and public universities, a months-long investigation by the Assembly Committee on Accountability and Administrative Review has found.

In many cases, school districts, colleges and universities signed contracts with boilerplate language that sanctioned the rebates, although public officials were not always aware of the practice and typically did not know what the rebates are worth.

Many contracts pay schools commissions or other payments, providing millions of dollars at some CSU and UC campuses. But it is unknown how those commissions and payments compare to the rebates collected under the often long-term agreements.

Several contracts reviewed by the Committee were silent on off-invoice rebates, raising questions in some cases about whether the rebates should have been remitted and may still be owed to the schools involved.

Federal and state guidelines prescribe a comprehensive set of rules for K-12 food service contracts, rules that are for the most part left to the California Department of Education (CDE) to enforce. But the Committee and federal auditors found CDE's contract-oversight arm understaffed and unable to effectively monitor most of the contracts negotiated by California school districts.

For example, state and federal guidelines require all K-12 food service contracts to be submitted to CDE for review and approval before they are signed and executed. Yet, CDE does not receive all contracts before they are put into place and does not have enough staff to review and monitor those contracts it does receive.

As a result, as many as 52 of some 170 K-12 food contracts in place in California (out of more than 1,100 districts statewide) may be in violation of rules that prohibit requiring districts to purchase all food supplies through a contractor's vendors, CDE officials confirmed. In addition, CDE officials said they believe food service contractors continue to collect questionable rebates under fixed-price contracts.

At UC and CSU campuses, the Committee found contracts in which food service contractors' off-invoice rebates apparently are not factored into agreed upon profit limits, operating expenses, net income calculations or evaluations of price increase requests, including those for student meal plans. In some cases, student meal plan rates increased sharply under new contracts. UC Irvine's contract included more than \$9 million in onetime payments plus ongoing commissions on net food sales. It also prescribed meal plan increases averaging 10 percent a year for the first three years.

Inquiries and information from the Committee and others also helped one community college renegotiate its food service contract last fall to eliminate net costs that were approaching \$200,000 per year.

New York Settlement Casts Spotlight on Off-Invoice Rebates – The Committee's investigation was inspired by a \$20 million settlement that the New York Attorney General's Office reached in July 2010 with Sodexo. The settlement resolved allegations that the giant, France-based company had overcharged New York public schools and universities by not remitting rebates collected from national and regional suppliers.

Former New York Assistant Attorney John Carroll, the lead prosecutor on the case, underscored several key findings of the investigation:

- Food service contractors leverage their purchasing power to negotiate rebates from national and regional suppliers who are used to serve all of their accounts.
- The payments are called off-invoice rebates and discounts because they are not reflected on invoices, operating statements or other records submitted to clients.
- The value of the rebates ranges from less than 5 percent to more than 50 percent of invoiced prices, but averages 10 percent to 15 percent.
- The collection and retention of off-invoice rebates is an industry-wide practice. While the settlement was reached with Sodexo, New York anticipates additional settlements with other food service companies.
- The practice is intentionally opaque, designed to conceal from clients the true wholesale costs of food products.
- Rebates create an inherent conflict of interest, pressuring local managers to make food choices based on maximizing rebate income rather than more important factors.
- Pressure to use approved national and regional suppliers, those that have agreed to pay rebates, restricts purchases from local farmers and vendors.

- New York pursued the rebates under the state's False Claims Act, which has a 10-year statute of limitations. (California's False Claims Act also has a 10-year statute of limitations.)
- Rebates did not become an important piece of the food service business model until 2000 to 2002.

Industry Cites Benefits of Purchasing Power, National Accounts – The food service industry says its clients benefit in many ways from the terms and reliability of the national and regional supply contracts that large, often multinational companies are able to negotiate. In addition to lower prices, the industry says the big suppliers ensure quality, safety and availability of products that also meet nutritional standards at the K-12 level.

Federal Audits Sounded Earlier Alarms About Rebates – The United States Department of Agriculture (USDA), which administers the \$12.5 billion National School Lunch Program, raised similar concerns about food industry rebates in audits that it conducted in 2002 and 2005. In response to a congressional request prompted by the New York settlement, the agency launched a third review of food service contracts last fall.

The two earlier audits were followed by revised federal guidelines, including an October 2007 rule that requires food service contractors to return any rebates associated with cost-reimbursement contracts. Food service companies were allowed to retain rebates under fixed-price contracts, which presumably factor rebates into the fixed-price bid, the USDA reasoned.

Most California K-12 districts with food service contracts transitioned to fixed-price agreements after the new USDA rule was released. But, while most of those food service agreements start out as fixed-price contracts, CDE officials said that in many cases they are finding food service companies continuing to seek reimbursements for invoiced purchases that do not reflect rebates.

The state Department of Education also is investigating a complaint from one school district that its food service contractor is collecting and refusing to disclose or remit off-invoice rebates.

Little State Oversight of K-12 Contracts – Managers of the Nutrition Services Division of the California Department of Education said budget cutbacks have left the division with less than one full position to review and track food service contracts. As a result, the state does not receive all contracts for review and approval before they are executed and does not have enough staff to review and monitor those contracts that are submitted in advance, CDE officials said.

Last November, the USDA cited "serious" deficiencies in CDE's contract oversight program, starting with the absence of "a standard procedure to review and monitor contracting activity between school food authorities and food service management companies," as required by federal regulations.

The state Department of Education has responded with, among other actions, a request for five positions to rebuild its contract oversight team. Although federal funds are available for the positions, the request so far has not been included in the governor's proposed budget. Similar requests have been denied in recent years, according to the CDE.

Both CDE and USDA officials said they anticipate continued expansion in food service contracting at the K-12 level as more districts eliminate central kitchens and take other steps to absorb deep budget cuts.

One District Demanded Rebates – Dozens of K-12 contracts reviewed by the Committee contained boilerplate, industry-drafted language that declared that rebates obtained through national or regional purchasing arrangements would be retained by the food service contractor.

The Committee found only one district, Merced Union High School District, which rewrote the boilerplate language to require the return of all rebates to the district. Nonetheless, district officials said they never received any rebates. Merced Union later decided to self-operate its food service program, a move that district officials said saved an estimated \$250,000-plus per year.

UC, CSU Campuses Signed Off on Rebates Without Knowing Their Value – Most UC and CSU campuses handle their own food service operations. Just three UC campuses – Davis, Irvine and San Francisco – contract out for most or all of their food services. Just six CSU campuses – Bakersfield, East Bay, Monterey Bay, San Bernardino, San Francisco and Stanislaus – likewise rely on private food service providers.

In response to questions posed by the Committee, representatives of all but CSU Monterey Bay, San Francisco State University and UC San Francisco said they were aware of off-invoice rebates but unaware of the rebates' value when they negotiated their contracts. Officials at Monterey Bay, SF State and UCSF said they were unaware of the rebates, even though their contracts contain industry language that appears to permit their contractors to keep the payments.

At UCSF, where university officials said they were unaware of the rebates or their value, the university has covered hundreds of thousands of dollars – a precise figure was unavailable when this paper was prepared – of operating deficits reported by its food service contractor. Yet university officials said they did not know whether those deficits may have been offset with off-invoice rebates from the contractor's national or regional suppliers.

In addition, UCSF agreed to renegotiate its contract less than a year after it was signed with an amendment that declared the food service provider was "not yet in a profitable position." The amendment reduced the contractor's required payments to UCSF.

At UC Davis, the contract contains profit caps that limited the food service provider's earnings under the agreement to 3 percent, and later 6 percent, with excess profits to be returned to the university. Those calculations have not included off-invoice rebates, university officials said. The contract was silent on such payments until 2009, when the profit cap was raised to 6 percent and the university agreed to incorporate the boilerplate language that allowed the contractor to keep the rebates. Since 1997-98, UC Davis received a total of \$63,236 in excess profits on sales of more than \$200 million.

The UC contracts, and many of those at CSU campuses, also outline procedures for requesting, considering and approving price increases under the contracts. In almost all cases, university officials said those calculations did not rely on changes in actual food costs, net of the off-invoice rebates.

At some UC and CSU campuses, contracts that paid the universities commissions on net sales – including sales of meal plans that are mandatory for many students – appeared to create an incentive for both the universities and their food service providers to increase prices.

While it's logical, and the industry contends that rebates from national suppliers allow food service companies to offer lower prices, that may not always happen. Officials at one CSU campus, Channel Islands, say their "cost of goods sold" – a basic wholesale barometer – is on target to drop more than 20 percent since the campus cancelled its food service contract in 2009. Over the last three years of that contract, CSU Channel Islands' cost of goods sold averaged 37.3 percent of total revenue, while the current year projection is 29.8 percent, according to a university representative.

Extent of Rebating in Community College Contracts Unknown – California has 72 community college districts, each of which operate as local government entities managed and controlled by locally elected boards. The California Community Colleges Chancellor's Office has no authority to review or pass judgment on local vendor contracts entered into by individual districts.

A sample of community college contracts reviewed by the Committee showed many of the same patterns found in the UC and CSU contracts. Off-invoice rebates were sanctioned by boilerplate industry language and at least one contract was silent on rebates, leaving open the question of whether rebates should have been remitted to that college.

During the course of the Committee's investigation, officials at Sierra College in Rocklin renegotiated an existing food service contract to eliminate a growing out-of-pocket expense that was approaching \$200,000 a year. Sierra College used information the Committee and others provided

about off-invoice rebates to help persuade the food service company to absorb any future operating deficits incurred in the operation.

Do Generally Accepted Accounting Principles Require Disclosure of Off-Invoice Rebates?—

Many contracts reviewed by the Committee contained clauses that require food service contractors to adhere to Generally Accepted Accounting Principles in reporting financial information.

Nonetheless, many school and university officials told the Committee they did not believe those guidelines, widely known as GAAP, require full disclosure and reporting of off-invoice rebates.

Representatives of Sierra College and San Francisco State disagreed, saying they do believe GAAP requires disclosure of actual costs of food and other supplies purchased under the contracts.

Michelle Yetman, an associate professor of accounting at the UC Davis Graduate School of Management, said GAAP requires distributors or resellers to account for manufacturers' material rebates as a reduction in the "cost of goods sold," the inventory cost reported on an income statement. So GAAP, Yetman explained, permits the receipt of rebates as long as they are accounted for correctly. Concealment of material rebates (not reporting them correctly in financial statements) would be a violation of GAAP, she said.