

Post-Hearing Questions for the Record

Submitted to

The Honorable Phyllis K. Fong, Inspector General, U.S. Department of Agriculture

From Senator McCaskill

**“FOOD SERVICE MANAGEMENT CONTRACTS: ARE CONTRACTORS
OVERCHARGING THE GOVERNMENT?”**

Wednesday, October 5, 2011, 2:00 P.M.

United States Senate, Subcommittee on Contracting Oversight,

Committee on Homeland Security and Governmental Affairs

1. It is my understanding that you have announced a new audit on the issues of rebates in the school lunch program. Is this a result of the settlement in New York?

Response: In part. In July 2010, Sodexo, a large food service management company (FSMC), settled with the Office of the Attorney General of the State of New York (OAG - NY) for improperly withholding rebates and credits from 21 school districts. U.S. Representative DeLauro, in a letter to the Secretary of Agriculture, requested that OIG conduct a review of contract school meal programs in other states to help identify and recover any federal funds that have been misappropriated through illegal procurement practices. Our current audit was initiated based on this request.

2. What areas do you expect this audit to cover?

Response: We will review school food authorities (SFAs) that signed cost-reimbursable contracts with FSMCs to ensure they were credited with all purchase discounts and rebates. We will also review fixed-rate-per-meal contracts to ensure the SFAs were credited with the full value of USDA-donated commodities. Additionally, we will assess the effectiveness of any controls implemented by the Food and Nutrition Service (FNS) and selected State agencies as a result of our previous audits.

3. When will the audit be released?

Response: According to our current plan, we expect it to be issued sometime in early summer 2012.

4. Many food service management companies use their own in-house food distributors. Should this make us more or less cautious in our oversight of their rebate practices?

Response: Although we have not completed a formal review of this practice, our sense is that it should make us more cautious and we may have some observations to offer after we complete our work. Tracing rebates/discounts may be difficult if an FSMC used an in-house food distributor and did not document those rebates/discounts on the invoices provided to the school. This is because transactions between such entities may not be at arms' length, thus necessitating additional work to determine if the prices charged by the in-house distributors are actually concealing some or all of the rebates being passed along to the FSMCs.

5. I have also learned of a practice called “silo-ing,” where the contractors buy food for all their clients and amass rebates based on the overall volume of purchases, but because all of the product is “silo-ed” together, the contractor can’t allocate the rebates to individual clients.

Is this a credible commercial practice?

Response: This is the first we have heard of the term “silo-ing,” but it is a relatively common business practice for FSMCs to purchase items in large quantities and receive volume discounts. In our prior audit work, the FSMCs we visited had internal records that allocated the discounts and rebates among the SFAs with which they had contracted. In our current audit, however, we will be looking further into this practice to assess whether the collection of discounts/rebates for products used for all of an FSMC’s clients (participating schools, hospitals, etc.) are being allocated properly back to the individual clients.

6. In your opinion, what are some of the biggest challenges for schools to effectively manage and oversee these contracts?

Response: One of the biggest challenges we have found is that school district officials have limited experience in identifying the value of discounts and rebates the FSMC received on their behalf.¹

FNS’ new rule and subsequent guidance, if followed, should assist school district officials in identifying the value of the FSMC discounts and rebates that they receive.

7. In your testimony, you highlighted some of the ongoing litigation and settlements that have occurred in rebate cases.

Is this a sign that the government has an idea of what is going on and how to prevent it or is it a sign that this problem is much bigger than we realize?

¹ In a prior audit, OIG stated that: “...SFAs were not always aware that they were entitled to be reimbursed for the value of commodities. SFAs were satisfied to have someone else take over their food service programs...One FSMC amended an SFA’s contract to remove the terms that would have required the FSMC to credit the SFA for purchase discounts and rebates...FSMC was allowed to disregard the terms of the request for proposal under which the contracts were awarded.” *See* 27601-24-Ch, *Food and Nutrition Service National School Lunch Program Food Service Management Companies – Midwest Region*, Sept. 2001.

Response: We do not know the full extent of the information that various government entities have on rebate cases, but we do believe that the recent litigation could indicate that the problems are more pervasive than first realized. These cases may prompt other States and school districts to initiate similar investigations that could uncover further non-compliance by FSMCs. We will be looking into underlying issues in our current audit.

8. Dating as far back as 1969, the Food and Nutrition Service (FNS) has issued guidance and prototypes for use by school districts when entering into agreements with Food Service Management Corporations, and has continually addressed this issue in the four decades since. In 2007, FNS provided explicit instructions to local schools regarding appropriate contractual provisions to ensure savings are passed on by the contractor.

In your view, is there anything unclear about the guidance provided by FNS?

Response: Our initial reading of FNS' recent guidance was that it was clear. After we complete our audit fieldwork and evaluate implementation of the guidance, we may be better positioned to provide a better assessment of the regulation.

9. Are you aware of any training FNS has undertaken to educate contractors, state agencies, and/or local school authorities about the guidance?

Response: Since we are just beginning our audit, we have not independently assessed the extent of the educational outreach FNS has conducted on the guidance. We did, however, ask FNS to provide information on the outreach they have undertaken. FNS advised as follows:

FNS has taken many steps since the release of the regulation in 2007, which includes the issuance of several policy memorandums in order to provide technical assistance and guidance to the SA and SFA. The most recent policy memo, issued on April 5, 2011, reaffirmed the requirement that SFAs must comply with Federal regulations affecting rebates, discounts and other applicable credits in all cost reimbursable contracts, including contracts with cost reimbursable provisions. FNS also developed a comprehensive guidance document on FSMCs for both the SA and the SFA.

Additionally, FNS has developed an online web training program that includes considerable discussion on the enforcement of contract provisions and the return of rebates, discounts and other applicable credits. The web-based procurement training is available online through The University of Mississippi's National Food Service Management Institute (NFSMI) at the following web address: <http://www.nfsmi.org>. The web-based training was originally created to provide a procurement training guide to help SAs administer the school meals programs. This training provides SAs with a better understanding of how best to perform responsibilities in the area of SFA procurements, and provides information on the Federal procurement process requirements, particularly the requirement for free and open competition. The overarching goal is to help the SAs, as well as the SFAs, understand the responsibilities for following regulations when providing nutritious meals to enrolled school children.

Last year the web-based training tool was opened up to Regional offices, SFAs and other interested parties. The web-based training is comprised of 3 topic areas which build upon

each other and move from more general procurement issues to more specific procurement issues such as FSMC contracts. Topic 1 and 2 are currently available; FNS is in the process of developing materials for Topic 3. Each topic provides close to 18 hours of course credit.

Lastly, FNS annually speaks at a minimum of 2 conferences to provide procurement training (i.e., School Nutrition Association, American Commodity Distribution Association). The audience at these conferences includes SAs, SFAs, ROs, FSMCs and other related industries.