



A REPORT
TO THE
ARIZONA LEGISLATURE

Performance Audit Division

Special Audit

Review of Selected State Practices for Information Technology Procurement

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Debra K. Davenport
Auditor General

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November 25, 2013

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Arizona State Senate

The Honorable Andy Tobin, Speaker
Arizona House of Representatives

Members of the Arizona Legislature

The Honorable Janice K. Brewer,
Governor

Mr. Brian C. McNeil, Director
Arizona Department of Administration

Transmitted herewith is a report of the Auditor General, *A Review of Selected State Practices for Information Technology Procurement*. This report is in response to Laws 2013, Ch. 100, and was conducted under the authority vested in the Auditor General by Arizona Revised Statutes §41-1279.03. I am also transmitting within this report a copy of the report highlights for this audit to provide a quick summary for your convenience.

As outlined in its response, the Arizona Department of Administration agrees with all of the findings and plans to implement all of the recommendations.

My staff and I will be pleased to discuss or clarify items in the report.

Sincerely,

Debbie Davenport
Auditor General

Attachment

cc: Clarence H. Carter, Director
Arizona Department of Economic
Security

John S. Halikowski, Director
Arizona Department of Transportation

Colonel Robert Halliday, Director
Arizona Department of Public Safety



REPORT HIGHLIGHTS SPECIAL AUDIT

Department's standard terms and conditions protect the State, but should be specialized for IT procurement

Our Conclusion

Pursuant to Laws 2013, Ch. 100, the Office of the Auditor General has conducted a special audit addressing selected state practices for information technology (IT) procurement as compared to other states. Specifically, we analyzed the State's practices in the areas of indemnification, liability, insurance, and warranties. As with other states we reviewed, Arizona's IT contracts help to protect the State from risk of loss, but would benefit from IT-specific contract templates. We also reviewed best practices for the ownership of intellectual property. Although Arizona's terms and conditions generally require state ownership of intellectual property for IT projects, the State should provide options for intellectual property ownership based on who pays for the development costs. In addition, we analyzed IT standardization and its impact on the procurement process. Although standardization can impact procurement, IT must still be purchased through a competitive procurement process.

SPO oversees the State's procurement process—The Arizona Department of Administration's (Department) State Procurement Office (SPO) administers the state laws and administrative rules that govern the procurement of goods and services for the State. SPO delegates procurement authority to state agencies, with or without limitations, based on state agencies' expertise, knowledge, and the impact on efficiency and effectiveness. Procurements exceeding an estimated \$100,000 are solicited through an invitation for bid or request for proposal, and contracts are awarded to the vendor whose offer is the most advantageous to the State. The Department has established uniform and special terms and conditions that are included in solicitations and become part of the awarded contract.

Terms and conditions transfer liability to vendors and help ensure product/service quality

The terms and conditions related to indemnification, liability, insurance, and warranties are intended to protect the State by transferring unlimited liability for potential claims to vendors and helping ensure the quality of materials and services provided. Although these terms and conditions are generally in line with the standard terms and conditions used in nine other states we reviewed, vendors we contacted expressed several concerns with them. In particular, vendors were concerned that the terms and conditions do not limit vendor liability, which they reported transfers too much financial

risk to them relative to the value of the contract. Additionally, although the State can negotiate these terms and conditions and did negotiate them in some contracts we reviewed, vendors expressed concerns regarding the State's willingness to negotiate. Some vendors indicated that these concerns affect their participation in the procurement process, such as not responding to a solicitation or submitting proposals with exceptions to the terms and conditions.

Department should develop IT-specific contract templates—IT-specific contract templates could help ensure that terms and conditions are appropriate, streamline the negotiation process, and help address some vendor concerns. The Department developed IT-specific contract terms and conditions in May 2012, including a provision that allows for limiting vendor first-party liability to an amount that is equal to or a specified multiple of the contract value. However, other states we reviewed have developed separate contract templates that are relevant to the procurement of IT materials and/or services. These templates provide terms and conditions that also can be modified prior to solicitations or through the negotiation process, as appropriate. States with these templates reported that the modifications have strengthened their relationship with vendors, reduced the need for negotiation, or increased efficiency in the procurement process.

Indemnification—An agreement to hold a party harmless in the event of loss or damage.

Liability—The legal responsibility to pay debts or other obligations.

Insurance—A contract between insurer and insured that indemnifies the insured by making payments in the event of certain losses.

Warranty—A promise that a claim is true.



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Recommendations

The Department should:

- Review existing terms and conditions;
- Seek direction from the Legislature and/or Governor, as appropriate;
- Develop and use specialized templates with IT-specific terms and conditions;
- Develop and implement policies and procedures to regularly review the templates; and
- Provide training and/or written guidance for the use and modification of templates.

Department should further modify intellectual property terms and conditions

The State's existing standard terms and conditions generally require state ownership of intellectual property created as a result of a contract. In contrast, the Federal Acquisition Regulation (FAR) provides for three options for intellectual property rights based on whether the government pays for all, a portion, or none of the development costs. Intellectual property rights were a concern for several vendors we interviewed, and vendors requested modifications to the intellectual property terms and conditions in most of the requests for proposal we reviewed, which the State agreed to in some cases. Although the Department created an IT-specific intellectual property provision in May 2012 that is similar to one of the FAR's options, it should include the options described in the FAR in the IT-specific contract templates we recommend that it develop.

Recommendation

The Department should include options for intellectual property rights, as described in the FAR, in the IT-specific contract templates.

IT standardization can impact procurement, but IT must still be purchased through a competitive procurement process

Standardization can occur at any level of an IT system, including computing platforms such as mainframes, servers, and personal computers; operating systems; and applications. The Department's Arizona Strategic Enterprise Technology Office is responsible for setting state-wide IT standards and standardization efforts. Some goals of standardization are to reduce costs and increase efficiencies. For example, the State has purchased a single, state-wide financial accounting system to be used by all agencies instead of each having its own system. Standardization can also affect specifications or the scope-of-work requirements for a particular solicitation. For example, an agency with specific requirements may develop solicitation specifications or scope-of-work requirements to ensure compatibility with existing systems. However, standardization can lead to state agency concerns about standards requiring changes to agency operations, increasing costs, or not meeting agency needs.

Although IT standardization can impact procurement, IT materials and services must still be competitively procured. Similar to Arizona, states we reviewed reported that they do not develop IT standards specifying a particular product or vendor and that contracts must be awarded through a competitive procurement process.

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INTRODUCTION

Scope and Objectives

Laws 2013, Ch. 100, required the Office of the Auditor General to conduct a special audit addressing the procurement of information technology (IT) materials and services. Specifically, the law required the audit to provide the following information:

- An analysis of the State's IT procurement methodology and strategies in comparison to other states for identification of best practices in the areas of warranties, indemnification, liability, and insurance (see Chapter 1, pages 3 through 11).
- Best practices for the management and ownership of intellectual property (see Chapter 2, pages 13 through 15).
- An analysis of IT platform standardization and its impact on the procurement process in comparison to other states (see Chapter 3, pages 17 through 19).

The law further directed the audit to focus on IT solicitations and contracts awarded for fiscal year 2012 by four state agencies as determined by the Auditor General. Agencies were selected based on volume of IT spending and are the Arizona Department of Administration, Arizona Department of Economic Security, Arizona Department of Public Safety, and Arizona Department of Transportation.

Finally, this report includes information on vendors who have state-wide IT contracts, but who receive little or no business from state agencies (see Other Pertinent Information, pages 21 through 22).

State laws and regulations govern IT procurement

Unless otherwise exempted by statute, state agencies are required to follow the Arizona procurement code when procuring materials and services, including IT materials and services (see textbox). The procurement code comprises various statutes and administrative rules administered by the State Procurement Office (SPO), which is a division of the Arizona Department of Administration (Department) and is led by a state procurement administrator. Although SPO serves as the central procurement authority for the State, the state procurement administrator may delegate limited or unlimited procurement authority to state agencies based on certain criteria, including expertise, knowledge, and impact on efficiency and effectiveness.¹ This allows an agency to make purchases up to its delegated dollar limit without SPO's involvement, although the agency must still follow the procurement code.

IT procurement—Statute defines IT as all computerized and auxiliary automated information processing, telecommunications, and related technology, including hardware, software, vendor support and related services, equipment, and projects. As such, IT procurement covers a wide array of materials and services, ranging from software applications, computers, and network equipment to IT consulting, web design, and maintenance and support services.

Source: Auditor General staff review of Arizona Revised Statutes §41-3501 and IT-related contracts.

The procurement code generally requires that contracts be awarded through a competitive sealed bidding process. This is done by issuing a solicitation, which is an invitation or request for vendors to submit offers (see textbox, page 2). Purchases estimated to exceed \$5,000 but less than \$100,000 should be solicited through a request for quotation, while purchases of \$100,000 or more should be solicited through an invitation for bid or a request for proposal. The procurement code requires that vendors' offers be evaluated based on how well they meet the requirements described in the solicitation. For a request for proposal, vendors are also evaluated on other factors, including their financial resources, personnel, and past performance. After evaluation, procurement officers may award the contract to the vendor whose offer is most advantageous to the State or negotiate with vendors to improve their offers in areas such as price, specifications, performance, or terms and conditions. In addition, SPO awards state-wide contracts through which state agencies and other political subdivisions can purchase materials and services without having to issue

¹ The Department has delegated unlimited procurement authority to the other three agencies included within the scope of the audit.

Types of competitive solicitations

Request for Quote (RFQ)—An informal solicitation method used for purchases estimated to exceed \$5,000 but less than \$100,000. Agencies are generally required to purchase from small businesses.

Invitation for Bid (IFB)—A formal solicitation method used for purchases estimated at \$100,000 or more. Contracts are awarded to the lowest responsible and responsive bidder that conforms in all material respects to the requirements and criteria set forth in the solicitation. IFBs are appropriate for procuring materials, such as large specialized printers and printer replacement parts, where negotiating terms and conditions is not necessary.

Request for Proposal (RFP)—A formal solicitation method used for purchases estimated to be \$100,000 or more. Unlike IFBs, the State may negotiate with responsible offerors that are susceptible for award. Contracts are awarded to offerors whose proposals are deemed to be the most advantageous to the State based on price and other factors. RFPs are appropriate for procuring materials and/or services, such as network equipment and services or state information systems, where negotiations may be necessary.

Source: Auditor General staff review of the Arizona Procurement Code.

individual solicitations (see pages 21 through 22 for Other Pertinent Information about state-wide contracts).¹

The State has established both uniform and special terms and conditions to help guide the preparation of solicitations. The uniform terms and conditions contain basic terms and conditions that generally apply to most types of purchases and are included in each solicitation. The special terms and conditions are optional, preapproved terms and conditions that can be used to supplement or override the uniform terms and conditions, as needed. For example, the uniform terms and conditions do not address insurance requirements, but various special terms and conditions can be used to do so. In addition, although the uniform terms and conditions require a 1-year warranty on materials, various special terms and conditions can stipulate a different warranty period, such as 90 days. The uniform and special terms and conditions included in the solicitation, as well as any modifications to them that are negotiated with vendors, then become part of the awarded contract.

¹ Other Arizona political subdivisions include cities, counties, school districts, and other special districts. As of September 2013, statute also allows certain nonprofit organizations to purchase from state-wide contracts.

CHAPTER 1

The Arizona Department of Administration (Department), in collaboration with the Attorney General's Office, has established standard terms and conditions related to liability, indemnification, insurance, and warranties designed to protect the State by transferring unlimited liability for potential claims to vendors and helping ensure the quality of materials and services provided. These terms and conditions are generally in line with those used by other states auditors reviewed, but vendors have expressed several concerns with them. Although the terms and conditions can be negotiated, vendors expressed concerns regarding the State's willingness to negotiate, which may affect their participation in the procurement process. To ensure that terms and conditions are appropriate for information technology (IT) procurements, the Department should develop and periodically review separate contract templates with IT-specific terms and conditions similar to other states' practices. Implementation of this practice could streamline the negotiation process and address some vendor concerns.

Department's standard terms and conditions protect the State, but should be specialized for IT procurement

Standard contract terms and conditions protect the State

The Department, in collaboration with the Attorney General's Office, has established uniform and special terms and conditions related to indemnification, liability, insurance, and warranties that are intended to protect the State (see textbox for definitions). Although auditors did not identify best practices regarding these specific terms and conditions, Arizona's terms and conditions are generally in line with standard terms and conditions in other states reviewed. Modifications to Arizona's terms and conditions may be negotiated with vendors, but some changes require the Department's approval.

Indemnification—An agreement to hold a party harmless in the event of loss or damage.

Liability—The legal responsibility to pay debts or other obligations.

Insurance—A contract between insurer and insured that indemnifies the insured by making payments in the event of certain losses.

Warranty—A promise that a claim is true.

Source: Gifis, S.H. (Ed.). (2003). *Law dictionary* (5th ed.). Hauppauge, NY: Barron's Educational Series, Inc.

Terms and conditions transfer liability to vendors and help ensure product/service quality—The terms and conditions related to liability, indemnification, insurance, and warranties are intended to protect the State. With some exceptions, these requirements are generally in line with standard terms and conditions used in nine other states that auditors reviewed.¹ Specifically:

- **Indemnification and liability**—The indemnification terms and conditions are intended to protect the State by transferring liability to vendors. Liability is the legal responsibility to pay debts or other obligations, such as damages awarded for first- and third-party claims

¹ Auditors reviewed the standard terms and conditions used by nine other states for IT procurement. These states were California, Iowa, Nevada, North Dakota, Oklahoma, Oregon, Pennsylvania, Texas, and Utah (see Appendix A, page a-1, for additional information on how these states were selected).

(see textbox). Specifically, the indemnification terms and conditions included in the solicitations transfer liability to vendors for third-party claims that are not caused by the State's negligence. In addition, the terms and conditions do not limit vendors' liability for first- and third-party claims, meaning that a vendor would need to pay the full amount of any awarded damages, including direct and indirect damages. According to department officials, these terms and conditions were developed because good business practices dictate protecting the State from claims or lawsuits resulting from alleged vendor negligence and because the Arizona Constitution prevents the limitation of damages that can be awarded in the event of a claim.¹ Further, statute prohibits the State from incurring any obligations for which there has not been an appropriation. Because a limitation of damages would make the State liable for any unpaid damages, such a limitation has the effect of creating a state obligation. However, Arizona Revised Statutes (A.R.S.) §41-621(V) gives the Department authority to limit the liability of a vendor who contracts with the State, and this can be negotiated on a case-by-case basis with approval from the Department's State Risk Manager (see pages 5 through 6 for additional discussion about negotiated modifications to terms and conditions).²

First- and third-party claims for damages

Damages—In law, damages are an award of money to be paid to a person or entity as compensation for loss or injury. Damages can be direct and indirect. Direct damages are compensation for actual losses, such as lost wages or medical bills, while indirect damages are compensation for intangible losses, such as pain and suffering.

First-party claim for damages—The State and the vendor that contracts with the State are first parties. Examples of potential claims by the State against a vendor could be for the costs associated with failure to develop a system in accordance with contract specifications or damage to state property.

Third-party claim for damages—A person or entity who is associated with neither the State nor the vendor but who suffered a loss or injury as a result of their actions could make a claim for damages. Examples of potential claims by a third party include a data breach that results in identity theft or a failure of a 911 system that leads to a lack of incident response. The affected persons could file a third-party claim for the damages to recoup their losses.

Source: Giffis, 2003

The nine other states auditors reviewed have similar standard terms and conditions that transfer liability to the vendor. Similar to Arizona, none of the states limit vendors' liability for third-party damages. However, six states limit vendors' liability for first-party damages. In addition, five of these six states use a default multiple of the contract value to limit this liability for certain types of IT purchases. Specifically, California limits liability to twice the amount of the contract value for purchases of IT goods, nonproject-related services, and low-risk IT

¹ A.R.S. Const. Art. 2, §31, and Art. 18, §6

² The State Risk Manager leads the Department's Risk Management division, which is responsible for protecting the State's assets from loss and minimizing employee injuries. The division provides insurance coverage to state agencies and employees for property, liability, and workers compensation losses.

projects.¹ Oregon limits liability to the amount of the contract value for software purchases and consulting services. However, officials from California and Oregon reported that these terms and conditions may be modified depending on the purchase.

- **Insurance**—The insurance terms and conditions require vendors to carry insurance against potential third-party claims for personal injury, death, and property damage, thus ensuring that vendors will have the financial means to pay claims. Vendors are also required to name the State as an additional-insured on the insurance policies. In addition, vendors are required to provide a certificate of insurance as proof of insurance, and may be required to provide copies of insurance policies upon request.

Similar to Arizona, all nine states require vendors to have insurance. Additionally, seven of the states require vendors to list the state as an additional-insured on their policies. Further, six of the states require certificates of insurance; however, only one other state also requires that vendors provide copies of insurance policies upon request.

- **Warranty**—The warranty terms and conditions require vendors to guarantee for a period of time that contract deliverables are free of liens, of industry quality, fit for their intended purpose, and compliant with applicable laws.² The terms and conditions provide four options for the warranty period length: 90 days, 1 year, lifetime guarantee, or any other length determined by the contracting agency. In addition, the terms and conditions require vendors to provide remedies for failure to meet these warranties. For example, some of the warranty special terms and conditions require that the contractor fully correct any defects in design, workmanship, or materials at no cost to the State. Vendors are required to maintain contractual insurance levels through the warranty period.

Similar to Arizona, six of the nine states require vendors to provide a warranty that products and services will perform as expected and/or meet contract specifications. The warranty period required by these states is either 90 days, 1 year, or not specified. However, only two of the nine states require a warranty for materials to be free of liens. In addition, only two other states require a warranty that products be fit for intended purposes.

Terms and conditions may be negotiated at the State’s discretion—The Department’s State Procurement Office (SPO) and state agencies with delegated procurement authority may negotiate modifications to terms and conditions when using a request for proposal (RFP); however, modifications to the indemnification and liability terms and conditions require approval from the Department’s State Risk Manager.³ Department officials reported that the decision to negotiate may depend on various factors, such as the State’s specific needs, the timing of the procurement, the particular industry, the competitive environment, and vendors’ responses to the RFP, which can either accept the terms and conditions as included in the RFP or propose alternative terms and

¹ A California official reported that California has since revised its terms and conditions to limit liability to the amount of the contract value effective November 2013.

² A lien is a charge, hold, claim, or encumbrance on property as security for some debt.

³ The State Risk Manager reviews requests for modifications to indemnification and liability terms and conditions based on the purchasing agency’s review of exposures and risk to assess the level of risk of loss to the State resulting from the requested modification. According to Risk Management, if the State Risk Manager approves exceptions, the purchasing agency agreeing to the exceptions becomes responsible for any first-party damages that exceed the vendor’s liability.

conditions. According to department officials, an evaluation of the initial responses to an RFP drives the basis or decision for negotiation; however, if qualified proposals are submitted without exceptions to the terms and conditions, the State may not need to negotiate. If qualified proposals request exceptions, negotiations may be necessary. Additionally, department officials indicated that negotiating on a case-by-case basis helps protect the State's interests by negotiating the terms and conditions only when necessary.

Still, these terms and conditions are negotiated in some contracts. Of the 14 IT-related RFPs issued or awarded in fiscal year 2012 that auditors reviewed, 3 contained modifications to the indemnification, liability, insurance, and/or warranty requirements in the awarded contracts.¹ For example, in the contract for replacing the Arizona Department of Transportation's (ADOT) ServiceArizona® Web site, the State negotiated a limitation of liability that limited the vendor's total liability to the value of the contract. All three vendors responding to the RFP had requested exceptions to various terms and conditions, and the limitation of liability was negotiated with the awarded vendor because ADOT felt this was an acceptable financial risk given its experience with the vendor.

Vendors have concerns regarding terms and conditions and negotiation process

Contract theory indicates that there is inherent tension between contracting parties who behave in their own best interests. Vendors that auditors contacted expressed several concerns regarding the State's standard terms and conditions for indemnification, liability, insurance, and warranties, as well as the State's approach to negotiations for IT procurements.² Specifically:

- **Standard terms and conditions concerns**—Of the four terms and conditions discussed in this chapter, vendors that auditors interviewed expressed the greatest concerns regarding liability.³ Specifically, several vendors indicated that the State's standard indemnification terms and conditions do not limit vendor liability. Some vendors claimed that not limiting total liability transfers too much financial risk to them relative to the value of the contract. In addition, some vendor representatives from publicly traded companies stated that agreeing to unlimited liability was unacceptable to their shareholders because it could affect their financial position. These vendors stated that, as a result, they generally submit proposals with exceptions to these terms and conditions, which could put them at a disadvantage compared to vendors who submit proposals without exceptions. For 6 of the 14 RFPs that auditors reviewed, one or more vendors proposed a change to the terms and conditions to limit liability. Additionally, as stated previously, although none of the nine states auditors contacted have standard terms and conditions that

¹ Auditors reviewed 27 IT-related solicitations issued or awarded in fiscal year 2012 of which 14 were issued through an RFP. An RFP is a type of formal solicitation for which terms and conditions may be negotiated (see Appendix A, page a-2, for additional information).

² To obtain vendor input, auditors interviewed six individual vendors and three vendor stakeholder groups. Auditors also conducted a survey of Arizona Technology Council members, a vendor stakeholder group whose membership includes approximately 175 IT companies according to the Arizona Technology Council's CEO. Twenty vendors responded to the survey. Auditors' conclusions regarding vendor concerns were based on a combination of evidence obtained from these methods. See Appendix A, page a-1, for additional information.

³ Vendors also expressed concerns with intellectual property terms and conditions (see Chapter 2, pages 13 through 15, for additional information).

limit vendors' liability for third-party damages, six states' standard terms and conditions limit vendors' liability for first-party damages (see page 8 for additional information regarding IT-specific special terms and conditions the Department issued in May 2012 that allow for limitation of vendors' first-party liability with department approval).

Some vendors also expressed concerns with other specific terms and conditions. For example, one vendor auditor interviewed expressed a concern with an additional requirement that vendors provide a copy of insurance policies upon request. This vendor expressed this concern because insurance policies, which contain sensitive information, would become public documents if requested. This same concern was noted by 2 vendors in their responses to 1 of the 14 RFPs auditors reviewed. The State Risk Manager stated that this requirement is included in the terms and conditions in case of a claim or lawsuit and that copies of insurance policies are rarely requested. As stated previously, only one other state that auditors reviewed requires vendors to provide copies of insurance policies upon request. Additionally, another vendor said it was difficult to comply with the warranty requirement that products be fit for intended purposes because vendors may not always know the intended purposes, or the purposes may evolve over time. As stated previously, only two other states that auditors reviewed require a warranty that products be fit for intended purposes.

- **Negotiation process concerns**—Although the State does negotiate terms and conditions with vendors, several vendors expressed concerns with the State's approach to negotiations. Specifically, some vendors auditors interviewed indicated that the State was unwilling to negotiate. Additionally, vendors responding to auditors' survey typically reported that the State was unwilling to negotiate, but vendors with experience in other states reported that Arizona was as willing or less willing to negotiate as compared to other states. Some vendors also reported that the State was inconsistent with regard to when it will negotiate. For example, one vendor stakeholder group indicated that the State appeared unpredictable when it would make exceptions to terms and conditions. Two vendors auditors interviewed stated they would like to know what terms and conditions are negotiable at the outset of the process because the preparation of a solicitation response can require significant effort. For 9 of the 14 RFPs that auditors reviewed, vendors requested exceptions to the indemnification, liability, insurance, and/or warranty terms and conditions. The State agreed to modifications to the terms and conditions in 3 of these 9 RFPs. In 2 of these 3 RFPs, auditors determined that all qualified vendors requested exceptions, thus requiring the State to negotiate these terms and conditions. Department officials acknowledged that there are inconsistencies in the negotiation process, but that consistency in negotiations is challenging because each IT procurement is unique. Department officials also indicated that, although some inconsistencies may be appropriate given the circumstances of a particular procurement, other inconsistencies in approach to, or expertise in, negotiations could be addressed through training.

Although some vendors indicated that they were likely to continue participating in the State's IT procurements under the existing terms and conditions and procurement process, some vendors indicated that they were not. Further, some vendors indicated that these concerns have affected their participation in the procurement process, including refraining from responding to a solicitation or submitting proposals with exceptions. Additionally, one vendor stated that it will not participate in solicitations with unlimited liability. Some vendors indicated that if they bid, their proposal price and

other specifications could be impacted to compensate for the State's terms and conditions. For example, in one RFP that auditors reviewed, a vendor's response to the RFP stated that it would be unable to provide the broad and extensive warranties proposed by the State without significantly impacting the vendor's price, and the vendor proposed modified warranty terms.

Department should develop contract templates with IT-specific terms and conditions

The Department should develop IT-specific contract templates to ensure that terms and conditions are appropriate for IT procurements. The Department has already developed some IT-specific terms and conditions. In late 2010 and early 2011, the Department worked with a vendor stakeholder group, the Attorney General's Office, and other state agencies to review its terms and conditions as it relates to IT procurement. As a result of these discussions, in May 2012, SPO issued special terms and conditions specific to IT purchases that include new terms and conditions in the areas of limitation of liability, indemnification, and warranties. One of the changes includes a provision that would allow the State to limit a vendor's first-party liability to an amount that is equal to a specified multiple of the contract value. For example, for a \$1 million contract with liability limited to three times the contract amount, the vendor would be responsible for only up to \$3 million for damages, even if the actual loss exceeded that amount. These new IT special terms and conditions can be used on a case-by-case basis to modify the uniform terms and conditions, but their use requires SPO's and/or the State Risk Manager's approval.

Other states that auditors reviewed have taken additional steps by developing IT-specific contract templates, including California, North Dakota, Oklahoma, Oregon, Pennsylvania, Texas, and Utah (see textbox on page 9 for examples).¹ As used in other states, these templates contain default terms and conditions—including, but not limited to, liability, indemnity, warranty, and insurance—that are relevant to the procurement of IT materials and/or services. The terms and conditions in the templates can be modified prior to solicitations or through the negotiation process, as appropriate. Some states have more than one template, used for different types of procurements. For example, Pennsylvania developed templates for IT services and software whose warranty terms and conditions differ from those used for all other procurements, including for IT materials. Specifically, the IT services template requires a remedy in the case of disruption of operations, while the software template requires that products be free of viruses, and the standard terms and conditions used for materials require repair or replacement of purchased items.

Many of these states reported that they developed IT-specific terms and conditions given the particular needs of IT procurement versus procurement of commodities. Many of these states also reported that the use of these templates has strengthened their relationship with vendors, reduced the need for negotiation, or increased the efficiency of the procurement process. Finally, some of these states reported that they periodically review their contract templates to ensure their continued appropriateness, which is consistent with best practice.

¹ States interviewed were California, Iowa, Nevada, North Dakota, Oklahoma, Oregon, Pennsylvania, Texas, and Utah. Auditors chose western states as well as states suggested by vendors and state officials (see Appendix A, page a-1, for additional information on how these states were selected).

Examples of other states' IT-specific contract templates

California—This state has developed a template for purchasing IT goods, nonproject-related services, and low-risk IT projects, and is in the process of revising this template with vendor input. California law requires that its repetitively used terms and conditions, including its IT-specific terms and conditions, be periodically renegotiated and that vendor input be solicited as part of that process.

Oregon—After reviewing its terms and conditions in 2010, Oregon developed six templates for four types of IT procurement, including hardware, software, IT services, and consulting. Each template contains terms and conditions appropriate for each type of procurement, which can be modified as necessary for each solicitation. The state began another review of its templates and the associated terms and conditions in 2013 with input from vendor representatives and reported that it plans to continue reviewing them every 2 to 3 years.

Source: Auditor General staff interviews with California and Oregon state officials, review of California state statutes, and review of contract terms and conditions used for IT procurements in those states.

Similar to these states, the Department should develop contract templates with IT-specific terms and conditions. This would help to ensure the appropriateness of the contract terms and conditions for IT procurements. Such IT-specific templates could also improve the efficiency of the procurement process and address some vendor concerns regarding the terms and conditions and negotiation process. As part of this process, the Department should:

- **Review existing terms and conditions**—The Department should undertake a review of terms and conditions used in IT procurements similar to the review it conducted in 2010 and 2011. However, it should consider all the requirements in the uniform and special terms and conditions and select all requirements that are relevant to IT procurements for review. The Department should obtain stakeholder input on these requirements from procurement, technology, risk management, and legal personnel, as well as representatives from state agencies and the vendor community, as appropriate.
- **Seek direction from the Legislature and/or Governor, as appropriate**—As the Department reviews and considers revising existing terms and conditions based on stakeholder input, it should seek direction from the Legislature and/or Governor, as appropriate. For example, in considering revisions that would limit vendors' liability, the Department should seek clarification regarding what revisions could be made within the Department's existing authority and what revisions would constitute new public policy that should be legislated prior to the Department taking action.
- **Develop and implement specialized templates of contract terms and conditions for IT procurements**—Once the Department has selected relevant IT-specific terms and conditions and considered or made revisions based on stakeholder input and direction from the Legislature and/or Governor, it should incorporate these IT-specific terms and conditions into a specialized contract template that it uses for IT procurements. Similar to two states, the Department should also consider developing separate templates for IT materials and services.
- **Develop and implement policies and procedures for regular review of templates**—The Department should develop and implement policies and procedures to guide the regular review

of the IT-specific terms and conditions included in its contract templates. These policies and procedures should indicate how frequently the terms and conditions should be reviewed and who should participate in the review.

- **Provide training and/or written guidance for the use and modification of templates**—The Department should provide training and/or written guidance to procurement officers at SPO and the state agencies with delegated procurement authority on how to use and modify the different templates, as needed.
- **Negotiate when appropriate**—Although developing contract templates with IT-specific terms and conditions may reduce the need for negotiation, the Department should negotiate terms and conditions for IT procurements, as necessary. The Department should also provide training and/or written guidance to procurement officers at SPO and state agencies with delegated procurement authority to reduce inconsistencies in the negotiation process that can be addressed through training.

Recommendations:

- 1.1 The Department should develop contract templates with IT-specific terms and conditions. Specifically, the Department should:
 - a) Undertake a review of terms and conditions used in IT procurements by considering all the requirements in the uniform and special terms and conditions, selecting all requirements that are relevant to IT procurements, and obtaining stakeholder input on these requirements from procurement, technology, risk management, and legal personnel, as well as representatives from state agencies and the vendor community, as appropriate;
 - b) In reviewing and considering revisions to existing terms and conditions based on stakeholder input, seek direction from the Legislature and/or Governor, as appropriate;
 - c) Based on its review, develop and implement a specialized template of contract terms and conditions for IT procurements. In addition, the Department should consider creating and using separate templates specific to procurement of IT materials and services;
 - d) Develop and implement policies and procedures to guide the regular review of the IT-specific terms and conditions included in its contract template(s). These policies and procedures should indicate how frequently the terms and conditions should be reviewed and who should participate in the review;
 - e) Provide training and/or written guidance to procurement officers at SPO and the state agencies with delegated procurement authority on how to use and modify the template(s); and

- f) Negotiate terms and conditions for IT procurements, as necessary, and provide training and/or written guidance to procurement officers at SPO and the state agencies with delegated procurement authority to reduce inconsistencies in the negotiation process that can be addressed through training.

CHAPTER 2

The Arizona Department of Administration (Department) should further modify its terms and conditions regarding intellectual property rights for information technology (IT) procurements. The existing standard terms and conditions generally require state ownership of IT contract deliverables, but state ownership may not always be necessary to ensure appropriate government use of these deliverables. In fact, the State agreed to modifications of these terms and conditions in some solicitations auditors reviewed. Federal regulation provides three options for intellectual property rights based on who pays for the IT development costs. Although the Department created an optional IT-specific intellectual property requirement in May 2012 that is similar to one of these options, it should provide options for intellectual property rights in the IT-specific contract templates recommended in Chapter 1 (see pages 3 through 11).

Department should further modify intellectual property terms and conditions

The Department should further modify its terms and conditions to provide options for intellectual property rights to ensure that the rights included in a particular IT solicitation are appropriate based on who pays for the IT development costs (see textbox). The existing uniform and special terms and conditions generally require state ownership of (1) all materials, products, and other deliverables developed in response to a contract with the State, and (2) any intellectual property created or conceived pursuant to or as a result of a contract. However, the State may not profit from ownership of intellectual property because Arizona Revised Statutes §41-2752 prohibits it from competing with private enterprise. In addition, although state ownership may be appropriate for some procurements, such as when all of the intellectual property for an IT project is developed solely at the State's expense, state ownership may not always be necessary to ensure appropriate government use of the acquired materials, products, or other deliverables. The Federal Acquisition Regulation (FAR) provides three options for intellectual property rights based on whether the government pays for all, a portion, or none of the development costs (see textbox, page 14).

Intellectual property rights—“Intellectual property” refers broadly to the creations of the human mind. Intellectual property rights protect the interests of creators by giving them property rights to use and profit from their creations. Creations that are protected by these rights include inventions, industrial designs, and trademarks.

Source: World Intellectual Property Organization. (2005). *Understanding industrial property* (WIPO Publication No. 895(E)). Geneva, Switzerland: Author.

Intellectual property rights were a concern for several vendors auditors interviewed.¹ For example, one vendor stakeholder group reported that intellectual property is vendors' most valuable asset and allows vendors to compete in the market. As a result, vendors have proposed changes to the State's intellectual property terms and conditions in response to specific requests for proposal (RFP). Specifically, vendors proposed modifications to the intellectual property terms and conditions in 11 of the 14 RFPs issued or awarded in fiscal year 2012 that auditors reviewed.² For example, some of these exceptions (1) clarified vendor ownership of preexisting intellectual property or (2) maintained vendor ownership of intellectual property while granting use rights to the State. The State agreed to modifications in 4 of these 11 cases. For 2 of these 4 RFPs, auditors determined that all qualified vendors

¹ Auditors interviewed six individual vendors and three vendor stakeholder groups, and used other methods to obtain vendor input (see Appendix A, page a-1, for additional information about these methods).

² Auditors reviewed 27 IT-related solicitations issued or awarded in fiscal year 2012, 14 of which were issued through an RFP (see Appendix A, page a-2, for additional information). An RFP is a type of formal solicitation for which terms and conditions may be negotiated.

FAR options for intellectual property rights

Government purpose rights—The rights to use, modify, reproduce, release, perform, display, or disclose intellectual property within the government without restriction and outside the government for noncommercial purposes only for a negotiated period of time. Upon expiration of that time frame, the government has unlimited rights to use the intellectual property. This right is appropriate for projects that use the vendors' preexisting intellectual property and intellectual property developed and paid for by the State. If agreed to, this requirement permits a government entity to use intellectual property and the vendor to have exclusive right to use intellectual property for commercial purposes for the specified time frame. For example, if the State issues a solicitation for a vendor with experience in developing human resources systems to develop a system that is tailored to the State's needs, it would be appropriate to include a government-purpose rights requirement in the solicitation. Under such an agreement, the vendor could continue to market and sell its system and expertise to other customers for the specified time frame.

Restricted rights—The rights to use, modify, reproduce, release, perform, display, or disclose intellectual property within the government. The government may not, without the written permission of the vendor, release or disclose the technical data outside the government. This type of intellectual property right is appropriate for items not developed in performance of a contract, i.e., they use the vendor's preexisting intellectual property. This type of requirement is used for acquisitions of software and other products that are also commercially available to the public, such as Microsoft Windows™ or Adobe Photoshop™. A government entity that agrees to this requirement does not own the intellectual property.

Unlimited rights—The rights to use, modify, reproduce, perform, display, release, or disclose intellectual property in whole or in part, in any manner, and for any purpose, whatsoever, and to have or authorize others to do so. The State would have this type of intellectual property right after government purpose rights expire or for projects where all intellectual property is developed at state expense. The vendor retains no rights, i.e., it may not use the intellectual property for future projects or transfer it to another entity. This type of intellectual property requirement would be appropriate for "work for hire" contracts where a vendor provides services such as database or Web site design.

Source: Auditor General staff review of 48 CFR 227.7203-5.

requested exceptions to the intellectual property terms and conditions, thus requiring the State to negotiate these terms and conditions. However, vendors who submit proposals with exceptions could be at a disadvantage compared to vendors who submit proposals without exceptions and run the risk that their proposals will not be considered. For example, in one RFP auditors reviewed, a vendor was excluded from further consideration because it requested an exception to the intellectual property terms and conditions in its response (see Chapter 1, page 7, for additional information about vendors' concerns with the negotiation process).

Although none of the nine states that auditors reviewed have adopted the specific FAR language in their standard terms and conditions, two states have implemented modified government purpose rights.¹ Specifically, Oregon's standard IT terms and conditions stipulate that contractors own their intellectual property, but they grant the state a license to use it. An Oregon procurement official reported that vendors were refusing to bid on solicitations that included "one-sided" terms and conditions requiring the state to own intellectual property rights. As a result, Oregon adopted a

¹ States interviewed were California, Iowa, Nevada, North Dakota, Oklahoma, Oregon, Pennsylvania, Texas, and Utah (see Appendix A, page a-1, for additional information on how these states were selected).

version of government purpose rights requirements that allow full government use but also allow vendors to continue to own and market the intellectual property that they develop. In addition, California's standard terms and conditions for IT goods, nonproject-related services, and low-risk IT projects stipulate that contractors own what they create for the state, but the state has an unlimited license to use those creations.

In May 2012, the Department created an IT-specific intellectual property provision that is similar to the FAR's government purpose rights. This provision grants the State the right to use intellectual property, although it does not transfer ownership of the intellectual property to the State after a specified period of time and its use is optional and requires department approval. Because the need for state ownership of intellectual property may vary depending on who pays for the IT development costs, the Department should include options for intellectual property rights, as described in the FAR, in the IT-specific contract templates recommended in Chapter 1 (see pages 3 through 11). These options should provide flexibility to ensure that the intellectual property rights included in a particular IT solicitation are appropriate for that solicitation. As discussed in Chapter 1, the Department should also provide training and/or written guidance on the appropriate use of these terms and conditions.

Recommendation:

- 2.1 The Department should include options for intellectual property rights, as described in the FAR, in the IT-specific contract templates recommended in Chapter 1 (see Recommendation 1.1, pages 10 through 11). These options should provide flexibility to ensure that the intellectual property rights included in a particular IT solicitation are appropriate based on who pays for the IT development costs. The Department should also provide training and/or written guidance on the appropriate use of these terms and conditions.

CHAPTER 3

Information technology (IT) standardization, which can include the process of developing standards for the repeated and consistent use of IT, can impact procurement, but IT materials and services must still be acquired in accordance with the procurement code. The Arizona Department of Administration (Department) is responsible for state-wide IT standardization efforts. IT standardization can affect what technology is procured, the number of procurements solicited, and which vendors are capable of responding to a solicitation. However, similar to other states auditors reviewed, the State's IT standards do not identify a specific product or a specific vendor to purchase from, and IT materials and services must still be purchased through a competitive procurement process.

IT standardization can impact procurement, but IT must still be purchased through a competitive procurement process

Department responsible for IT standardization

Standardization can occur at any level of an IT system, including computing platforms such as mainframes, servers, and personal computers; network equipment; operating systems; and software applications. IT standardization can include the process of developing and implementing standards for the repeated and consistent use of IT.¹ IT standards can address various business requirements, such as the interoperability and compatibility of IT systems, information sharing, and security.² Additionally, IT standardization can be achieved through an IT governance structure that specifies the decisions, rights, and accountability framework for IT investments.³ It can also be achieved by standardizing business processes or unit functions, or through existing preferences (also called de facto standardization; see page 21 for more information about de facto standards).⁴

The Department's Arizona Strategic Enterprise Technology Office (ASET) is responsible for setting state-wide IT standards and state-wide IT standardization efforts. Specifically, ASET is responsible for developing state-wide IT policies and standards; reviewing and approving state agencies' IT plans and projects valued at \$25,000 or more; and developing a coordinated state-wide IT plan. ASET uses an enterprise architecture approach that provides a framework of business principles, best practices, technical standards, and migration and implementation strategies that direct the design, deployment, and management of IT for state agencies. The State has also standardized some business processes; for example, all state agencies use one payroll system for human resource management.

¹ Van Wessel, R.M. (2008). *Realizing business benefits from company IT standardization*. Doctoral dissertation, University of Tilburg, Netherlands; *Digital government: Building a 21st century platform to better serve the American people*. (n.d.) Washington, DC: The Obama Administration, Office of Management and Budget, Office of E-Government & Information.

² National Association of State Chief Information Officers. (2005). *IT procurement & enterprise architecture: Recognizing the mutual benefits* (Research Brief). Lexington, KY: Author.

³ Pardo, T. A. & Burke, G.B. (2009). *IT governance capability: Laying the foundation for government interoperability*. Albany, NY: University of Albany, Center for Technology in Government.

⁴ Van Wessel, 2008

Standardization can impact procurement, but procurement code must still be followed

IT standardization can have several impacts, many of which can affect procurement. For example:

- Some goals of standardization are to reduce costs and increase efficiencies by eliminating duplicative purchases and having fewer types of IT to support.¹ This could affect the type of IT materials or services solicited and the number of solicitations issued. For example, the State has purchased a single, state-wide financial accounting system to be used by all state agencies, instead of having multiple systems purchased by individual agencies. As a result, standardization can lead to fewer procurements, as well as fewer contracts to negotiate and manage.
- Standardization can also affect the specifications or scope-of-work requirements developed for a particular solicitation. Specifically, standards can define the requirements that an IT product or solution should meet. This could also involve the need to ensure continued compatibility and interoperability with existing IT systems, hardware, and/or software. For example, an agency with specific networking requirements may develop specifications or scope-of-work requirements within a solicitation to ensure compatibility with its existing systems. This could affect which vendors are able to meet those requirements and respond to a solicitation, although this would be true of any procurement. Further, changes to IT standards could require contracts to be resolicited if the vendors holding the contracts cannot meet the new standards.
- However, standardization can lead to state agency concerns about a central technology agency, such as ASET, imposing IT standards that could require changes to agency operations, increase agency costs, or that may not meet agency needs. For example, one state agency expressed concerns that a standardized IT system may not provide the specific capabilities needed by the agency. Additionally, there may be costs associated with switching to a new standard, and these costs may outweigh the potential benefits of switching to the new standard. Further, standardization could delay some solicitations while a consensus is reached on what IT materials and/or services need to be procured.

Although standardization can impact procurement, IT materials and services must still be purchased through a competitive procurement process. According to Arizona Revised Statutes §41-2501(B), the procurement code applies to all expenditures of public monies, including IT procurements. Although the State has standardized around specific applications, the State's IT standards outline various requirements for IT systems but do not identify a specific product to purchase or a specific vendor from which to purchase. Additionally, contracts for IT materials and services must still be awarded through a competitive procurement process. This is consistent with nine other states auditors interviewed regarding their approach to developing IT standards.² All of these states have a state technology agency responsible for setting state-wide IT standards. Similar to Arizona, these

¹ Van Wessel, 2008

² These states were California, Iowa, Nevada, North Dakota, Oklahoma, Oregon, Pennsylvania, Texas, and Utah (see Appendix A, page a-1, for additional information on how these states were selected).

states reported that they do not develop IT standards specifying a particular product or vendor.¹ This approach is consistent with literature, which indicates that standards should be flexible enough to adapt to the changing environment.² Further, all nine states reported that IT contracts must be awarded through a competitive procurement process.

¹ A Pennsylvania official reported that the state may still have a few standards citing a product, but was moving away from product-specific standards. In addition, an Oklahoma official reported that, although IT contracts are typically awarded through a competitive procurement process, Oklahoma has the ability to negotiate directly with providers for contracts that are establishing a state-wide technology standard.

² Van Wessel, 2008

Other Pertinent Information

During the course of the audit, auditors identified an additional procurement issue regarding concerns from vendors who have state-wide contracts for information technology (IT) materials or services, but receive little or no business from state agencies. This section of the report has no recommendations, but provides information regarding the Arizona Department of Administration's (Department) use of state-wide contracts and how the Department and other states respond to this vendor concern.

Vendor concerns regarding state-wide contracts

The Department's State Procurement Office (SPO) awards state-wide contracts through which state agencies and other political subdivisions can purchase materials and services, such as toner cartridges and network equipment.¹ SPO issues state-wide contracts for commonly used materials and services. These contracts allow SPO to negotiate price discounts and other favorable terms—such as maintenance and service agreements—for all purchases made through these contracts. They also eliminate the need for agencies to issue individual solicitations for similar materials and services. Additionally, Arizona state executive branch agencies are generally required to make purchases from state-wide contracts and may purchase from any vendor with a contract. Agency decisions regarding these purchases could lead to what are termed de facto standards (see textbox).

De facto standard—A type of informal standard that develops once a specific product or service gains a certain acceptance rate. For example, there may be no formal standard requiring the use of a specific operating system; however, every personal computer at a particular agency may be running Microsoft Windows™. De facto standards may be based on preference; familiarity or experience with a product, service, or vendor; or other reasons.

Source: Van Wessel, R. M. (2008). *Realizing business benefits from company IT standardization*. Doctoral dissertation, University of Tilburg, Netherlands.

SPO may award contracts for specific materials and services to one or more vendors depending on various factors, such as the State's needs or industry practices, but some vendors may not receive business. For example, SPO has awarded state-wide contracts for telecommunications carrier services to nine vendors. However, according to department reports, although state agencies and/or political subdivisions purchased from five of the vendors, four vendors did not receive business from these entities in fiscal year 2013.

Although the state-wide contracts specify that holding a contract does not guarantee business, the Department reported that vendors occasionally express concern when they hold a state-wide contract but do not get much business from state agencies. SPO does not require state agencies to justify which state-wide contracts they purchase from. However, according to a SPO official, SPO will look into vendors' concerns. This official also stated that when SPO finds that these decisions are based on de facto standards, it will

¹ Other Arizona political subdivisions include cities, counties, school districts, and other special districts. As of September 2013, statute also allows certain nonprofit organizations to purchase from state-wide contracts.

encourage state agencies to re-assess their decisions, as appropriate. According to this official, SPO will also remind vendors of their responsibility to market themselves.

Some other states indicated that their vendors have conveyed similar concerns. All nine states that auditors interviewed reported that they may also award state-wide contracts to multiple vendors and generally require state agencies to purchase from these contracts.¹ Similar to Arizona, six of the nine states reported that they do not require state agencies to justify why they purchased from certain state-wide contracts, although some of these states reported that they may encourage or instruct agencies to negotiate with multiple state-wide contract vendors. However, Pennsylvania requires state agencies to obtain quotes from contracted vendors for purchases above \$10,000 when multiple vendors are awarded a state-wide contract, and Utah requires state agencies to obtain quotes for all purchases. In addition, North Dakota reported that agencies may be required to obtain offers from multiple vendors on state contract depending on the type of IT purchase and estimated cost. Finally, when responding to vendor concerns, similar to Arizona, many of these states reported that their contracts include language that holding a state-wide contract does not guarantee business and that it is up to vendors to market themselves to the state agencies.

¹ The nine states were California, Iowa, Nevada, North Dakota, Oklahoma, Oregon, Pennsylvania, Texas, and Utah (see Appendix A, page a-1, for additional information on how these states were selected).

APPENDIX A

Methodology

This appendix provides information on the methods auditors used to meet the audit objectives.

The Auditor General and staff express appreciation to officials and staff from the Arizona Department of Administration (Department), the Arizona Department of Economic Security (ADES), the Arizona Department of Public Safety (ADPS), and the Arizona Department of Transportation (ADOT) for their cooperation and assistance throughout the audit.

Auditors used the following methods to meet these objectives:

- Interviewed officials and staff from the Department, ADES, ADPS, and ADOT, and reviewed these agencies' procurement policies and procedures, statutes and administrative rules comprising the Arizona Procurement Code, applicable articles of the Arizona Constitution, the State's uniform and special terms and conditions, and other applicable information.
- Reviewed the Arizona Strategic Enterprise Technology Office's policies and procedures regarding information technology (IT) project approval and standardization.
- Interviewed procurement and/or IT officials from California, Iowa, Nevada, North Dakota, Oklahoma, Oregon, Pennsylvania, Texas, and Utah and reviewed applicable documentation from these states. Auditors selected states primarily based on geographic location (i.e., western states), but also selected states that were mentioned by literature, experts, and/or agency officials.¹
- Reviewed literature in the areas of outsourcing, contract development, procurement, intellectual property rights, and IT standardization.
- Reviewed the Federal Acquisition Regulation for model language for intellectual property terms and conditions in government contracting.
- Interviewed a former president of the National Association of State Chief Information Officers and a member of the National Association of State Procurement Officials.
- Interviewed six individual vendors and three vendor stakeholder groups.² Additionally, auditors conducted a survey of Arizona Technology Council (Council) members regarding the terms and conditions included in the audit scope and the State's procurement process, to which 20 vendors responded. The Council is a trade association for science and technology companies that works to advance technology in Arizona. According to its CEO, council membership includes approximately 175 IT companies.

¹ Auditors also contacted procurement and/or IT officials in Colorado, New Mexico, New York, South Carolina, and Washington. However, for various reasons, officials from these states either did not respond to interview requests or did not provide sufficient documentation to support information stated in interviews.

² Auditors contacted four additional vendors who did not respond to auditors' requests for interviews.

- Reviewed all 27 IT-related solicitations from the Department, ADES, ADPS, and ADOT that these agencies identified as being issued or awarded in fiscal year 2012. These solicitations included 14 requests for proposal, 6 invitations for bid, 3 requests for quotation, 2 emergency procurements, and 2 sole-source procurements. Auditors also reviewed an additional request for proposal issued and awarded in fiscal year 2013 that used IT-specific special terms and conditions developed by the Department in May 2012.

AGENCY RESPONSE



Janice K. Brewer
Governor

Brian C. McNeil
Director

ARIZONA DEPARTMENT OF ADMINISTRATION

OFFICE OF THE DIRECTOR

100 NORTH FIFTEENTH AVENUE • SUITE 401
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(602) 542-1500

November 19, 2013

Debbie Davenport, Auditor General
Office of the Auditor General
2910 North 44th Street, Suite 410
Phoenix, Arizona 85018

Re: Preliminary Report - Review of Selected State Practices for Information Technology Procurement

Dear Ms. Davenport:

Thank you for providing the revised report on the review of state practices for Information Technology (IT) procurements. We have reviewed the report in its entirety and provide the following responses to the findings/recommendations:

1.1 The Auditor General finds that the Department should develop terms and conditions templates for IT procurements, as well as policies, guidelines and training for the use of said terms and conditions. The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

The Department is in agreement with the finding and will proceed with implementation. We think it is important to note, though, that implementation will require significant effort to undertake the actions outlined in the finding. A high level of subject matter expertise, knowledge, and time is necessary to develop the envisioned skills. Consequently, we anticipate needing to address a number of matters over time (e.g., staff recruitment/retention, compensation and training) in order to have successful outcomes.

Until implementation is complete, the Department will continue to promote its current policy for IT Terms and Conditions that was formulated in collaboration with the vendor community and the Attorney General's Office (TB 046; Attachment 1).

2.1 The Auditor General finds that the Department should assess intellectual property language in its standard terms and conditions, using federal regulations as a baseline, and subsequently provide training for procurement officers. The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Thank you for the opportunity to provide the Department's comments on the Preliminary Report.

Sincerely,

Brian C. McNeil
Director



ARIZONA DEPARTMENT OF ADMINISTRATION
STATE PROCUREMENT OFFICE

TECHNICAL BULLETIN No. 046

TITLE **Information Technology Terms and Conditions Usage**
REVISION **Number 0**
DATE **05/03/12**

I. Authority

A. Applicable Statute

- A.R.S. § 41-2511 Authority of the Director
A.R.S. § 41-2512 Delegation of Authority by the Director
A.R.S. § 41-2585 Contract Clauses
A.R.S. § 41-2553 Procurement of Information Systems and Telecommunications Systems

B. Applicable Administrative Code

- A.A.C. R2-7-201 State Procurement Administrator; Duties and Qualifications
A.A.C. R2-7-202 Delegation of Procurement Authority to State Procurement Units
A.A.C. R2-7-203 Agency Chief Procurement Officer
A.A.C. R2-7-601 Contract Clauses
A.A.C. R2-7-606 Terms and Conditions

II. Definitions

- A. Agency Chief Procurement Officer. The person within a state governmental unit, identified by the agency head, who is acting under specific, written authority from the State Procurement Administrator in accordance with R2-7-202.
- B. Contract Clause. A written requirement within a contract that provides appropriate remedies, adjustments in pricing or performance and other provisions.
- C. Uniform Terms and Conditions. Contract clauses that are required for all state contracts, usually mandated by statute or rule.
- D. Special Terms and Conditions. Contract clauses that are in addition to the required Uniform Terms and Conditions and address contract performance requirements throughout the life cycle of the Contract.
- E. Information Systems and Technology. A system of hardware, software or vendor support costing more than one hundred thousand dollars that processes information or data by electronic data processing methods and devices.
- F. State Procurement Office. An office that acts under the authority delegated to the State Procurement Administrator.
- G. State Governmental Unit. Any department, commission, council, board, bureau, committee, institution, agency, government corporation or other establishment or official of the executive branch or corporation of this state.

TITLE **Information Technology Terms and Conditions Usage**
REVISION **Number 0**
DATE **May 3, 2012**

III. Policy

- A. **Purpose.** The purpose of this policy is to ensure the proper utilization of authorized terms and conditions for the procurement of information technology goods and services.
- B. **Authorized Use.** State governmental units may utilize State Procurement Office established information technology terms and conditions, only after seeking written authorization and approval from the State Procurement Administrator.
1. If authorization is provided by the State Procurement Administrator, the State governmental unit shall ensure that the subject terms and conditions are inserted within the solicitation or contract's special terms and conditions to ensure maximum protections as provided by the contract's order of precedence.
- C. **Appropriate Situations for Use.** Utilization and application of the information technology terms and conditions, shall be reserved for those procurements including, but not limited to the following:
1. Significant dollar investments, enterprise wide deployments, or large scale integration and implementation procurements that meet or exceed the threshold as stated and defined in A.R.S. §41-2553; or
 2. The complexity of the technical requirements, and potential impact of award on state government operations, is so great, that it is determined, without the flexibility afforded by using these terms and conditions, the State governmental unit may not possibly negotiate a favorable outcome;
 3. The need to ensure increased competition from multiple qualified vendors.

IV. Effective

This Technical Bulletin is hereby authorized and effective this 3rd day of May, 2012, unless otherwise revised or repealed.

Jean A. Clark, FNIGP, CPPO, CPPB, C.P.M.
State Procurement Administrator

This publication is not intended or represented to be the official record of laws and regulations covered under statutes, A.R.S. 41-2501 et seq., and administrative rules and regulations A.A.C. R2-7-101 et seq., that constitute the Arizona Procurement Code ("Code"). In the event of a discrepancy between this publication and applicable statute and rule, statute and rule shall prevail.

INFORMATION TECHNOLOGY SPECIAL TERMS & CONDITIONS

LIMITATION OF LIABILITY

[New Provision -May be used on case-by-case basis at State's discretion]

First Party Limitation of Liability

Contractor's liability for first party damages to the State arising from this Contract shall be limited to _____ time(s) the maximum-not-to-exceed amount of this Contract. The foregoing limitation of liability shall not apply to: (i) liability, including indemnification obligations, for third party claims, including but not limited to, infringement of third party intellectual property rights; (ii) claims covered by any specific provision of the Contract calling for liquidated damages or other amounts, including but not limited to, performance requirements; or (iii) costs or attorneys' fees that the State is entitled to recover as a prevailing party in any action.

INDEMNIFICATION

Contractor shall indemnify, defend with counsel reasonably approved by the State, and hold harmless, the State, its departments, agencies, boards, commissions, universities, officers, agents and employees (collectively, the "Indemnitee") from and against any and all claims, actions, damages, costs (including attorneys' fees), and losses arising under this Contract, including, but not limited to, bodily injury or personal injury (including death) or loss or damage to tangible or intangible property, but excluding damages arising solely from the gross negligence or willful misconduct of the Indemnitee. This indemnification obligation includes any claim or amount arising out of, or recovered under, the Workers' Compensation Law or arising out of the failure of Contractor to comply with any federal, state or local law, statute, ordinance, rule, regulation or court decree. Contractor shall have control, subject to the reasonable approval of the State, of the defense of any action on such claim and all negotiations for its settlement or compromise, provided, however, that when substantial principles of government or public law are involved, or when involvement of the State is otherwise mandated by law, the State may elect, in its sole and absolute discretion, to participate in such action at its own expense with respect to attorneys' fees and costs, but not liability, and the State shall have the right to approve or disapprove any settlement, which approval shall not be unreasonably withheld or delayed. The State shall reasonably cooperate in its defense and any related settlement negotiations.

IP INDEMNIFICATION

Indemnification - Patent and Copyright. With respect solely to Materials provided or proposed by Contractor or Contractor's agents, employees, or subcontractors (each a "Contractor Party") for performance of this Contract, Contractor shall indemnify, defend and hold harmless the State, its departments, agencies, boards, commissions, universities, officers, agents and employees (collectively, the "Indemnitee"), against any third-party claims for liability, including, but not limited to, reasonable costs and expenses, including attorneys' fees, for infringement or violation of any patent, trademark, copyright or trade secret, by such Materials or the State's use thereof.

In addition, with respect to claims arising from computer hardware or software manufactured or developed solely by a third party, Contractor shall pass through to the State such indemnity rights as it receives from such third party (the "Third Party Obligation") and will cooperate in enforcing them; provided, however, that (i) if the third party manufacturer fails to honor the Third Party Obligation, or (ii) the Third Party Obligation is insufficient to fully indemnify the State, Contractor shall indemnify, defend and hold harmless the State against such claims in their entirety or for the balance of any liability not fully covered by the Third Party Obligation.

The State shall reasonably notify the Contractor of any claim for which Contractor may be liable under this section. If the Contractor is insured pursuant to A.R.S. § 41-621 and § 35-154, this section shall not apply. Contractor shall have control, subject to the reasonable approval of the State, of the defense of any action on such claim and all negotiations for its settlement or compromise, provided, however, that when substantial principles of government or public law are involved or when involvement of the State is otherwise mandated by law, the State may elect, in its sole and absolute discretion, to participate in such action at its own expense with respect to attorneys' fees and costs, but not liability, and the State shall have the right to approve or disapprove any settlement, which approval shall not be unreasonably withheld or delayed. The State shall reasonably cooperate in the defense and any related settlement negotiations.

If Contractor believes at any time that any Materials provided or in use pursuant to this Contract infringe a third party's intellectual property rights, Contractor shall, at Contractor's sole cost and expense, and upon receipt of the State's prior written consent, which shall not be unreasonably withheld, (i) replace an infringing Material with a non-infringing Material; (ii) obtain for the State the right to continue to use the infringing Material; or (iii) modify the infringing Material to be non-infringing, provided that following any replacement or modification made pursuant to the foregoing, the Material continues to function in accordance with the Contract. Contractor's failure or inability to accomplish any of the foregoing shall be deemed a material breach of this Contract.

Notwithstanding the foregoing, Contractor shall not be liable for any claim for infringement based solely on any Indemnitee's:

- (i) modification of Materials provided by Contractor other than as contemplated by the Contract or the specifications of such Materials or as otherwise authorized or proposed in any way by Contractor or a Contractor Party;
- (ii) use of the Materials in a manner other than as contemplated by this Contract or the specifications of such Materials, or as otherwise authorized or proposed in any way by Contractor or a Contractor Party; or
- (iii) use of the Materials in combination, operation, or use with other products in a manner not contemplated by the Contract, or, the specifications of such Materials, or as otherwise authorized or proposed in any way by Contractor or a Contractor Party.

Contractor certifies, represents and warrants to the State that it has appropriate systems and controls in place to ensure that State funds will not be used in the performance of the Contract for the acquisition, operation or maintenance of Materials in violation of intellectual property laws.

INTELLECTUAL PROPERTY

Ownership of Intellectual Property. Any and all intellectual property, including but not limited to copyright, invention, trademark, trade name, service mark, or trade secrets created or conceived solely pursuant to or as a result of this Contract and any related subcontract (collectively, the "Intellectual Property"), shall be work made for hire and the State shall be the owner of such Intellectual Property. The agency, department, division, board or commission of the State of Arizona requesting the issuance of this Contract shall own (for and on behalf of the State) the entire right, title and interest to the Intellectual Property throughout the world. Software and other Materials developed or otherwise obtained by or for Contractor or its affiliates independently of this Contract ("Independent Materials") do not constitute Intellectual Property. If Contractor creates derivative works of Independent Materials, then the elements of such derivative works created pursuant to this Contract shall constitute Intellectual Property owned by the State. Contractor shall notify the State, within thirty (30) days, of the creation of any Intellectual Property by it or its subcontractor(s). Contractor, on behalf of itself and any subcontractor(s), agrees to execute any and all document(s) necessary to assure ownership of the Intellectual Property vests in the State and shall take no affirmative actions that might have the effect of vesting all or part of the Intellectual Property in any entity other than the State. The Intellectual Property shall not be disclosed by Contractor or its subcontractor(s) to any entity not the State without the express written authorization of the agency, department, division, board or commission of the State of Arizona requesting the issuance of this Contract.

[New Provision -To be located elsewhere in solicitation documents]

Notwithstanding the foregoing, if the State elects, in its sole and absolute discretion, to relinquish its ownership interest in any or all of the Intellectual Property, the State shall have the rights to use, modify, reproduce, release, perform, display, sublicense or disclose such Intellectual Property within State government and operations without restriction for any activity in which the State is a party (collectively, "Government Purpose Rights").

WARRANTY

Warranties

Liens. The Contractor warrants that the Materials supplied under this Contract are free of liens and shall remain free of liens.

Quality. Unless otherwise modified elsewhere in the terms and conditions, the Contractor warrants that, for one year after acceptance by the State, the Materials shall be:

- Of a quality to pass without objection in the trade under the Contract description;
- Fit for the intended purposes for which the Materials are used;
- Conform to the written promises or affirmations of fact made by the Contractor; and
- Fully compatible with the State's computer hardware and software environment.

Fitness. The Contractor warrants that any Materials supplied to the State shall fully conform to all requirements of the Contract and all representations of the Contractor, and shall be fit for all purposes and uses required by the Contract.

Inspection/Testing. The warranties set forth in subparagraphs 7.1 through 7.3 of this paragraph are not affected by inspection or testing of or payment for the Materials by the State.

Compliance with Applicable Laws. The Materials and services supplied under this Contract shall comply with all applicable Federal, state and local laws, and the Contractor shall maintain all applicable license and permit requirements.

Contractor represents and warrants to the State that Contractor has the skill and knowledge possessed by members of its trade or profession and Contractor will apply that skill and knowledge with care and diligence so Contractor and Contractor's employees and any authorized subcontractors shall perform the Services described in this Contract in accordance with the Statement of Work.

Contractor represents and warrants that the Materials provided through this Contract and Statement of Work shall be free of viruses, backdoors, worms, spyware, malware and other malicious code that will hamper performance of the Materials, collect unlawful personally identifiable information on users or prevent the Materials from performing as required under the terms and conditions of this Contract.

Survival of Rights and Obligations after Contract Expiration or Termination.

Contractor's Representations and Warranties. All representations and warranties made by the Contractor under this Contract shall survive the expiration or termination hereof. In addition the parties hereto acknowledge that pursuant to A.R.S. § 12-510, except as provided in A.R.S. § 12-529, the State is not subject to or barred by any limitations of actions prescribed in A.R.S. Title 12, Chapter 5.

Purchase Orders. The Contractor shall, in accordance with all terms and conditions of the Contract, fully perform and shall be obligated to comply with all purchase orders received by the Contractor prior to the expiration or termination hereof, unless otherwise directed in writing by the Procurement Officer including, without limitation, all purchase orders received prior to, but not fully performed and satisfied at the expiration or termination of, this Contract.

Performance Audit Division reports issued within the last 24 months

11-14	Arizona Game and Fish Commission Heritage Fund	13-02	Arizona Board of Appraisal
12-01	Arizona Health Care Cost Containment System— Coordination of Benefits	13-03	Arizona State Board of Physical Therapy
12-02	Arizona Health Care Cost Containment System—Medicaid Eligibility Determination	13-04	Registrar of Contractors
12-03	Arizona Board of Behavioral Health Examiners	13-05	Arizona Department of Financial Institutions
12-04	Arizona State Parks Board	13-06	Department of Environmental Quality—Underground Storage Tanks Financial Responsibility
12-05	Arizona State Schools for the Deaf and the Blind	13-07	Arizona State Board of Pharmacy
12-06	Arizona Health Care Cost Containment System—Medicaid Fraud and Abuse Prevention, Detection, Investigation, and Recovery Processes	13-08	Water Infrastructure Finance Authority
12-07	Arizona Health Care Cost Containment System—Sunset Factors	13-09	Arizona State Board of Cosmetology
13-01	Department of Environmental Quality—Compliance Management	13-10	Department of Environmental Quality—Sunset Factors
		13-11	Arizona State Board of Funeral Directors and Embalmers
		13-12	Arizona State Board for Charter Schools
		13-13	Arizona Historical Society

Future Performance Audit Division reports

Arizona Game and Fish Commission and the Arizona Game and Fish Department