NAU Bookstore:
Contract with Follett Higher Education Group

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Report Number FY 18-06

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Northern Arizona University
Contract with Follett Higher Education Group
Internal Audit Report
June 18, 2018

Summary

Northern Arizona University’s (NAU / University) agreement with the Follett Higher Education Group (Follett) is included on the University’s Annual Audit Plan for Fiscal Year 2018, as approved by the Audit Committee of the Arizona Board of Regents. This audit supports NAU’s strategic goals of Stewardship and Student Success and Access by ensuring the propriety of contractual provisions related to commission payments and availability of pertinent student resources. NAU Internal Audit previously audited compliance with the Follett agreement in fiscal year 2011.

Background: The NAU Bookstore (Bookstore) includes the primary physical store at NAU’s Mountain Campus and physical satellite stores in the Skydome and at NAU’s Prescott Valley Campus. Through e-commerce, the Bookstore also serves the entire NAU community, including Online and Off-Campus initiatives.

The University outsourced Bookstore management to Follett effective December 7, 2006. The current agreement is effective June 2015 through December 2026, with an option to renew for two additional five-year terms. All Bookstore personnel are employed by and report to Follett, including the Bookstore manager. Due to administrative restructuring, contract oversight and administration was moved from NAU’s Finance and Administration Cabinet to Enrollment Management and Student Affairs (EMSA) during the Fall 2016, early 2017 time period.

For fiscal year 2017, Follett reported total gross sales of $10,145,455 including $10,050,486 in commissionable sales; related commissions paid to NAU were $1,378,852. See Exhibit A for more details on Bookstore operations under Follett management.

Audit Objective: To determine whether NAU Management is monitoring the Bookstore contract with Follett for compliance with key contract requirements.

Scope: Review and assess current NAU processes for monitoring compliance with the Follett contract, with a focus on key contract requirements, including 1) verifying the accuracy and completeness of commission calculations, 2) measuring and reporting customer satisfaction, and 3) ensuring that other terms of the contract are being fulfilled. Analysis of transaction detail focused on fiscal year 2017 through March 31, 2018.

Methodology: The following procedures were performed:

- interviewing Follett’s management and certain representatives at the Bookstore to gain an understanding of their procedures to process transactions, maintain inventory control, and solicit customer feedback;
- determining whether Follett’s summary of gross sales receipts were supported by detailed sales reports and that contractual commission rates were properly applied;
- recalculating commissions due NAU from Follett’s summary reports of gross sales;
- confirming NAU’s financials accurately reported quarterly commissions received from Follett;
- recalculating the pricing on a sample of 34 transactions to confirm compliance with the contract pricing requirements; and,
- verifying compliance with other contractual terms, including customer satisfaction, providing scholarships for textbooks, providing funds for marketing and Athletics, and contributing $3 million to remodel the bookstore in 2015.
Conclusion:

Follett appears to generally be in compliance with key contract terms and the commissions paid to NAU are supported by the Bookstore’s commissionable gross sales as reported by Follett. However, NAU oversight of the contract could be improved especially relative to validation of commissionable sales and commission payments; and, certain contract terms could be clarified to improve the ability to monitor agreement compliance. Without adequate reports and oversight, it is not possible to verify the completeness of revenues subject to commissions, quality of service provided and thereby ensure Follett compliance with the key agreement terms. Similar improvement opportunities were identified in the report issued in March 2011 and the change in oversight to EMSA represents action to improve contract management.

Observations:

Prior to December 2006, NAU operated the Bookstore as a profitable auxiliary and for fiscal years 2000 through 2006, the Bookstore generated annual net revenues (after operating expenses) averaging $280,131. The outsourcing arrangement continued and enhanced the profitable trend as commission revenues paid to NAU improved as noted in our March 2011 audit and over the past several years indicate contract benefit to both NAU and Follett, as reflected below:

Note that in the current textbook market including the online availability of non-digital textbooks and related educational resources / supplies, pricing is relatively well-controlled by the national market. The University’s and Follett’s ability to impact sales and margins is thereby limited, making focus on the Bookstore “experience” a more prominent focus.

While external to the Follett agreement, Herff Jones is currently the exclusive vendor for all NAU graduation regalia, class rings, and memorabilia, with Follett working through an arrangement with Herff Jones that existed prior to Follett assuming management of the Bookstore. Neither Internal Audit nor NAU management could identify an official agreement with Herff Jones. To ensure the best possible arrangement for NAU students, NAU management is analyzing the arrangement with Herff Jones and will work with Purchasing to determine the best approach going forward.

NAU Management is supportive of our recommendations and has actively begun working to implement identified solutions.
The control standards considered and the status of the related control environment are provided in the following table.

<table>
<thead>
<tr>
<th>General Control Standard</th>
<th>Control Environment/Assessment</th>
<th>IO No.</th>
<th>Page No.</th>
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<tbody>
<tr>
<td>Reliability and Integrity of Financial and Operational Information:</td>
<td></td>
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<tr>
<td>• Follett has implemented appropriate policy, procedure and process to support agreement compliance related to point of sale collections, inventory management and revenue recognition.</td>
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<tr>
<td>• The NAU General Ledger properly reflects commissions and other payments required of Follett per the agreement.</td>
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<td>Safeguarding of Assets:</td>
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<tr>
<td>• All commissions and other payments due from Follett per the agreement were accurately and timely paid and accounted.</td>
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<td>2</td>
<td>7</td>
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<tr>
<td>• Inventories required per agreement are properly maintained/managed.</td>
<td></td>
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<td>Effectiveness and Efficiency of Operations:</td>
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<tr>
<td>• Follett has implemented appropriate policy, procedure and process to support agreement compliance related to effective bookstore oversight and customer (NAU management, faculty and student) satisfaction.</td>
<td></td>
<td>2</td>
<td>7</td>
</tr>
<tr>
<td>Compliance with Laws and Regulations:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Agreement terms are clearly articulated to facilitate effective agreement implementation and oversight by NAU and Follett.</td>
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<td>2</td>
<td>7</td>
</tr>
<tr>
<td>• NAU effectively monitors Follett performance to ensure ongoing agreement compliance.</td>
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<td>5</td>
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</table>

Legend:

- Reasonably Strong Controls In Place
- Opportunity for Improvement
- Significant Opportunity for Improvement

We appreciate the assistance provided by EMSA and Follett management and staff.

Mark P. Ruppert, CPA, CIA, CISA
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AUDIT RESULTS: Improvement Opportunities & Solutions

1. **NAU could improve its oversight and monitoring to ensure Follett compliance with key agreement terms.**

   **Solution:** EMSA will implement the following routine and periodic monitoring and oversight procedures to ensure effective implementation of the agreement and provide for the best possible Bookstore experience for NAU faculty, students and visitors:

   - Commissions will be validated for each payment including follow-up if not timely remitted, verification of gross sales by category and recalculation of applicable contractual commission rates. More detailed analysis will also be performed periodically or as the circumstances may warrant.
   - A schedule of Follett payments due per contract (scholarships, etc.) will be created and monitored to ensure timely submission of all payments due.
   - Biweekly meetings with the Follett Bookstore Manager will include a review of customer feedback and, at the close of each semester, summaries will be reviewed and provided to the Vice President of Enrollment Management and Student Affairs.
   - The aforementioned biweekly meetings are and will be used to continue focusing on Bookstore performance, service and contractual compliance. As digital content evolves, pricing and related commission considerations will be discussed.

   Additionally as noted in Improvement Opportunity 2, agreement updates have already been discussed with Follett and Follett will provide EMSA management with a proposed amendment addressing various contract clarifications including those noted in this report. An executed amendment is anticipated by or before September 30, 2018.

   **Responsible Parties:**
   TC Eberly, Executive Director, CSA Administration
   Mark Boyer, Director, CSA Administration

   **Implementation Date:**
   September 30, 2018

**DETAILS:**

**Condition:** As previously noted, oversight of the Bookstore agreement was moved to EMSA during the Fall 2016 / early 2017 time period, about a year before we started the audit. As reported by management and supported by the lack of related documentation, formal processes for oversight had not been passed on to EMSA from which they could easily transition oversight and mature such processes. Also, as noted in Improvement Opportunity 2, the complexity of the agreement, including how the agreement is documented, makes it challenging in some instances to ensure a proper understanding of the contractual obligations and expectations. As such contractual oversight processes were still maturing as the audit commenced and thereby appeared informal relative to ensuring Follett is effectively performing its contractual duties, especially in the following three areas:

   a) **Proper calculation of commissions due and timely submission of commission payments:**

      There is no evidence supporting formal and detailed commission monitoring as documentation had not been obtained supporting the calculation of commission payments to support review and validation of sales and related commission calculations. Effective monitoring could be
AUDIT RESULTS: Improvement Opportunities & Solutions

achieved by obtaining and validating Follett reports, including their monthly commission calculation, monthly profit and loss statements, net monthly sales reports by department, gross sales by commissionable sales category, tender reports, sample cost and sales data for merchandise to validate pricing, and any other data deemed necessary for validation. While we noted no material variances in our commission calculation testing, documentation supporting immaterial variances was not readily available and we noted two instances where the quarterly commissions were received later than required; specifically, commission payments for the quarters ended:

- September 30, 2017 were not received until January 18, 2018.
- June 30, 2015 were not received until September 1, 2015 (under the former Follett agreement and NAU contract management team).

b) Accurate and timely payment of scholarship and other annual financial support required by the agreement:

NAU management appears to rely on Follett for ensuring such payments are made as required. While all such payments appear up to date, the most recent Athletics support payment per the contract had been prepared but not provided to NAU until after the check expired, in part due to the newly assigned Follett manager’s lack of knowledge and in part the lack of a defined process for handling the payment.

c) Analysis and follow-up of customer satisfaction surveying:

While Follett has implemented a customer survey that is solicited on each sales receipt, there was no indication that any feedback had been reviewed and evaluated by NAU.

Review of changes in Bookstore processes to ensure desired impact on faculty and students, including decisions related to pricing, markup, etc. To date, with no evidence of adequate contractual or national market cost controls, Follett has passed through vendor/publisher pricing plus standard margin on digital content and electronic course materials, which is a changing and maturing technology.

Criteria: Sound business practices include protection of University resources by ensuring contractually secured services are provided as desired and intended for the benefit of the University. The Bookstore management agreement includes specific terms for everything from inventory management to the management of sales to support required commission payments. Specifically, relative to the three conditions noted above, the agreement provides for the following:

a) Follett will make payments to the University on a quarterly basis within thirty (30) days of the end of each quarter (RFP 16.1.2) and the University may charge interest on all outstanding receivables thirty (30) days past due (RFP 16.1.5). The agreement also provides that Follett will submit a “financial report with each quarterly payment” (RFP 16.3.1).

b) Follett will provide certain annual support payments including $20,000 to Athletics and $50,000 to support annual textbook scholarships (RFP 16.1.10).

c) Follett will perform customer surveys as required by the University with results shared with the University for evaluation and input (RFP 19.3).

d) NAU will always have final approval over any bookstore management decisions (RFP 14.5).

e) Follett will charge industry standard, competitive and fair prices (RFP 16.2.2).
AUDIT RESULTS: Improvement Opportunities & Solutions

**Cause:** Our observations suggest a positive relationship between NAU management and the Bookstore manager and staff, but many of the reports necessary to confirm commission payments are generated at Follett’s corporate headquarters. Questions and explanations relating to the reports often need to be directed to the staff at corporate headquarters.

Additionally, Follett performance under the agreement has been positive to date, especially since the original outsourcing in December 2006. As noted in the report Conclusion, commissions improved greatly with Follett that reflect a generally increasing trend.

**Effect / Impact:** Lapses in agreement compliance could go undetected resulting in lost commissions or other payments due the University; poor service to faculty, students and or visitors; unnecessary liability resulting from poor maintenance; etc.

2. The Bookstore management agreement between NAU and Follett could be improved.

**Solution:** Agreement updates have already been discussed with Follett and Follett will provide EMSA management with a proposed amendment addressing various contract clarifications including those noted in this report. An executed amendment is anticipated by or before September 30, 2018.

**Responsible Parties:**
- TC Eberly, Executive Director, CSA Administration
- Mark Boyer, Director, CSA Administration

**Implementation Date:** September 30, 2018

**DETAILS:**

**Condition:** Various documents make up the final contract, which contribute to the agreement complexity by not delineating the key service level agreements (SLAs) in one coherent document. The agreement is documented via high level summary with references to addenda, pricing proposals and the supporting request-for-proposal (RFP) submitted by Follett at the time of initial contract solicitation. While most of this contractual documentation includes the requirements or SLAs that can be readily monitored to ensure compliance, the following improvements should be pursued to improve contractual understanding and oversight going forward:

a. The current commission arrangement and annual guaranteed minimum commissions of $900,000 does not match the corresponding information in the documented contract, addenda and pricing proposal available at NAU. Current agreement terms should be formally documented to avoid confusion.

b. Commission payments are currently made quarterly per contract. However, Follett management noted that many Universities are paid commissions on a monthly basis, which would be easier to monitor given the monthly nature of most of Follett’s reporting. Monthly payments would also improve cash flow to the University.

c. The nature of the financial reports that Follett must provide supporting each commission payment is not currently specified in the report. While Follett management readily provided
AUDIT RESULTS: Improvement Opportunities & Solutions

Internal Audit with requested information, the key reports / data necessary to validate commissions and other key agreement compliance should be specified in the agreement.

d. Contract details and requirements could be clarified by:
   - Organizing all or key SLAs in one document.
   - Identifying the process for valuing returned books (used books purchased from students).
   - Specifying acceptable range of markup for general merchandise.
   - Identifying responsibility for choosing the vendor for graduation regalia, class rings, etc.
   - Identifying the commission calculation process for all digital sales and the “other commissions” category of sales.

Criteria: Contract language should support the ability to monitor contract performance as required of each party.

Cause: There is no formal process for contract oversight or review. Oversight of the NAU Bookstore has been reassigned to various administrative areas several times. In FY 2017, contract administration was transferred from the Finance and Administration Division to Enrollment Management and Student Affairs. In FY 2017, the NAU Bookstore also had a change in management.

Effect / Impact: Agreement requirements could be misinterpreted and applied by Follett in a manner not intended and desired by NAU, resulting in lost revenue and/or disappointed customers.
EXHIBIT A – Additional Bookstore Background

The NAU Bookstore includes a primary physical store at NAU’s Mountain Campus with physical satellite stores in the Skydome and at NAU’s Prescott Valley Campus. Through e-commerce, the Bookstore also serves the entire NAU community, including NAU’s extended campuses and distance learning initiatives, via the Bookstore’s online presence. In addition to textbooks, other education materials and computer hardware, the Bookstore sells general merchandise, including apparel, gifts and supplies.

Beginning December 7, 2006, the University outsourced the NAU Bookstore to Follett. The original agreement expired in 2015. A new agreement was negotiated effective June 2015 through December 2026, with an option to renew for two additional five-year periods. The agreement is structured to move the responsibility for Bookstore operations to Follett with Follett providing the University with revenue-based commissions. All Bookstore personnel are Follett employees. While NAU continues to be responsible for overall building maintenance, Follett pays for all Bookstore related utilities.

Follett uses the JDA Distributed Store System® as its point-of-sale system. The system maintains a daily transaction history and updates perpetual inventory records. It is also used to balance sales receipts with cash and cash equivalents. Follett uses its proprietary software, Courseworks®, to price and inventory textbooks and trade books.

Follett guarantees minimum annual commissions of $900,000, paid to the University quarterly. Commissions are calculated based on sales, net of tax. Most sales, including textbook rentals, are used to calculate commissions. However, some sales are exempt from commissions, including: 1) sales of digital textbooks and 2) discounted sales to departments, faculty, and staff. The commission rate structure is as follows:

<table>
<thead>
<tr>
<th>Commissionable Sales Revenue</th>
<th>Percentage per below or $900,000, whichever is greater.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commissionable Sales up to $10,000,000</td>
<td>16% of revenue up to $10 million</td>
</tr>
<tr>
<td>Revenues exceeding $10,000,000</td>
<td>17% of revenue over $10 million</td>
</tr>
<tr>
<td>Revenues from computer systems, including peripherals</td>
<td>1.5% of revenues</td>
</tr>
</tbody>
</table>

In FY 2017, Follett reported gross sales on behalf of NAU of $10,145,455, of which total commissionable sales were $10,050,486. Fiscal year 2017 commission payments totaled $1,378,852, summarized as follows:

<table>
<thead>
<tr>
<th>FY2017 Bookstore Commission Payments</th>
<th>Sales</th>
<th>Commissions</th>
</tr>
</thead>
<tbody>
<tr>
<td>16% of revenue up to $10M</td>
<td>$8,469,621</td>
<td>$1,355,139</td>
</tr>
<tr>
<td>17% of revenue over $10M</td>
<td>$   0</td>
<td>$    0</td>
</tr>
<tr>
<td>1.5% of revenues from computer systems, including computer peripherals</td>
<td>$1,580,865</td>
<td>$23,713</td>
</tr>
<tr>
<td>Totals</td>
<td>$10,050,486</td>
<td>$1,378,852</td>
</tr>
</tbody>
</table>

Additionally, per the Bookstore agreement, Follett supported and continues to support NAU as follows:
- In 2015, Follett provided a one-time payment of $3,000,000 to remodel and make capital improvements to the Bookstore, with the related “contribution” to the University being amortized over 20 years. The remodel was completed August 2016.
- An annual contribution of $20,000 is provided for the support of the Athletic programs.
- Annual textbook scholarship funds of $50,000 are provided to support NAU students.