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Testimony

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DEPARTMENT OF
DEFENSE

Improving the DOD
Payment Process, Using
Recovery Auditing and
Changing the Prompt
Payment Act

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Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to discuss the Department of Defense's (DOD) payment problems and how recovery auditing is being used to identify and recover overpayments. I will also make some comments on changes to the Prompt Payment Act. To put these issues in perspective, in fiscal year 1998, DOD spent about \$115 billion contracting for goods and services. DOD contract dollars account for about two-thirds of total federal government contract spending for goods and services. Thus, it is vital that DOD have sound controls to ensure that contract payments are proper, accurate, and timely.

Results in Brief

The need for DOD to achieve effective control over its payment process remains an imperative. If DOD does not, it will continue to risk erroneously paying contractors hundreds of millions of dollars and perpetuating other financial management and accounting control problems. Further, improving the efficiency of the payment process could save millions of dollars annually in reduced processing costs.

While DOD is taking steps to improve its payment process and controls, it will likely take many years before DOD gets its payment problems under control. The focus of DOD's actions needs to be on making better use of technology to improve and integrate its payment systems and to streamline and simplify its payment requirements. These actions will, however, require sustained top-management efforts.

DOD needs to also concentrate on reducing overpayments and, recognizing that some overpayments are inevitable, adopt best practices to quickly identify and recover them. We believe that recovery auditing offers a low-risk opportunity to achieve both these goals, and we are supportive of the recently introduced legislation to require federal agencies to use recovery auditing.

Currently, contractors are not required to inform the government when they have been overpaid. Contractors should be required to notify the government of overpayments when they become aware of them. This requirement should not impose a significant burden on the contractor. Once notified, government contracting personnel should immediately ask contractors to refund the overpayment.

It may be time to raise the minimum dollar threshold required by the Prompt Payment Act. Currently, the Defense Finance and Accounting Service (DFAS) pays interest amounts that are less than it costs them to process the checks. However, raising the threshold should be part of an overall assessment of the efficiency of the payment process.

Erroneous DOD Payments Are a Long-standing Issue

In recent years, our reports have identified hundreds of millions of dollars in erroneous government payments, and interest expense on late payments, and other financial management problems. For example, in March 1994, we reported that during a 6-month period in fiscal year 1993, DFAS in Columbus, Ohio—a principal DOD contract paying activity—processed \$751 million in payments returned by defense contractors.¹ Our examination of about one-half of these checks disclosed that about 78 percent represented overpayments by the government. We also found that while some contractors returned overpayments, others did not. In one case, an overpayment of \$7.5 million was outstanding for 8 years. We estimate that the government lost interest on the overpayment amounting to nearly \$5 million. We concluded that neither DOD nor some contractors appeared to be aggressively pursuing resolution of payment discrepancies.

DOD continues to make substantial erroneous payments to its contractors. For example, in the 5 years between fiscal year 1994 and 1998, defense contractors returned about \$4.6 billion to DFAS Columbus—in fiscal year 1998, they returned \$746 million. However, some contractors were still retaining overpayments. For example, 4 of the 13 contractors we visited during a recent review were retaining overpayments totaling about \$1.1 million. At each location contractor personnel told us that they had a practice of retaining overpayments until the government issued a demand letter requesting the overpayments be returned.² There is no requirement for contractors who have been overpaid to notify the government of overpayments or to return overpayments prior to the government issuing a demand letter for a refund. The magnitude of overpayments defense contractors are retaining is not known.

¹DOD Procurement: Millions in Overpayments Returned by DOD Contractors (GAO/NSIAD-94-106, Mar. 14, 1994).

²A demand letter is a formal notification to the contractor that it owes the government money.

We have also found problems that contribute to improper and fraudulent payments. For example, in September 1998, we reported on internal control and system weaknesses that contributed to two cases of Air Force vendor payment fraud—one resulting in the embezzlement of over \$500,000 and the other resulting in embezzlement of \$435,000 and attempted theft of over \$500,000.³ We found that the lack of segregation of duties and other control weaknesses created an environment where employees were given broad authority and the capability, without compensating controls, to perform functions that should have been performed by separate individuals under proper supervision. We also found that over 1,800 DFAS and Air Force employees had access to the vendor payment system that allowed them to submit all the information necessary to create fraudulent and improper payments.

In testimony before the Congress earlier this year, the DOD Inspector General commented on the vulnerability of DOD finance operations, particularly to fraud in the vendor pay area. According to the Inspector General, the Defense Criminal Investigative Service (DCIS), an arm of the DOD Inspector General, is working with the DFAS to decrease that vulnerability through such measures as increased fraud awareness training. She said at the time that DCIS has about 80 open criminal investigations related to finance operations.

Factors Contributing to Erroneous Payments

In an April 1997 report,⁴ we concluded that DOD's erroneous payments are due, in part, to (1) nonintegrated computer systems that often require data to be entered manually, and with data that are often erroneous or incomplete and (2) payments that are required to be allocated among numerous accounting classifications. In addition, these factors increase the cost of paying contract invoices.

The need for DOD to effectively control its payment process remains imperative. If DOD does not, it will continue to risk erroneously paying contractors hundreds of millions of dollars and perpetuating other financial management and accounting control problems. Further, improving the efficiency of the payment process would save additional millions of dollars

³Financial Management: Improvements Needed in Air Force Vendor Payment Systems and Controls (GAO/AIMD-98-274, Sept. 28, 1998).

⁴Contract Management: Fixing DOD's Payment Problems Is Imperative (GAO/NSIAD-97-37, Apr. 10, 1997).

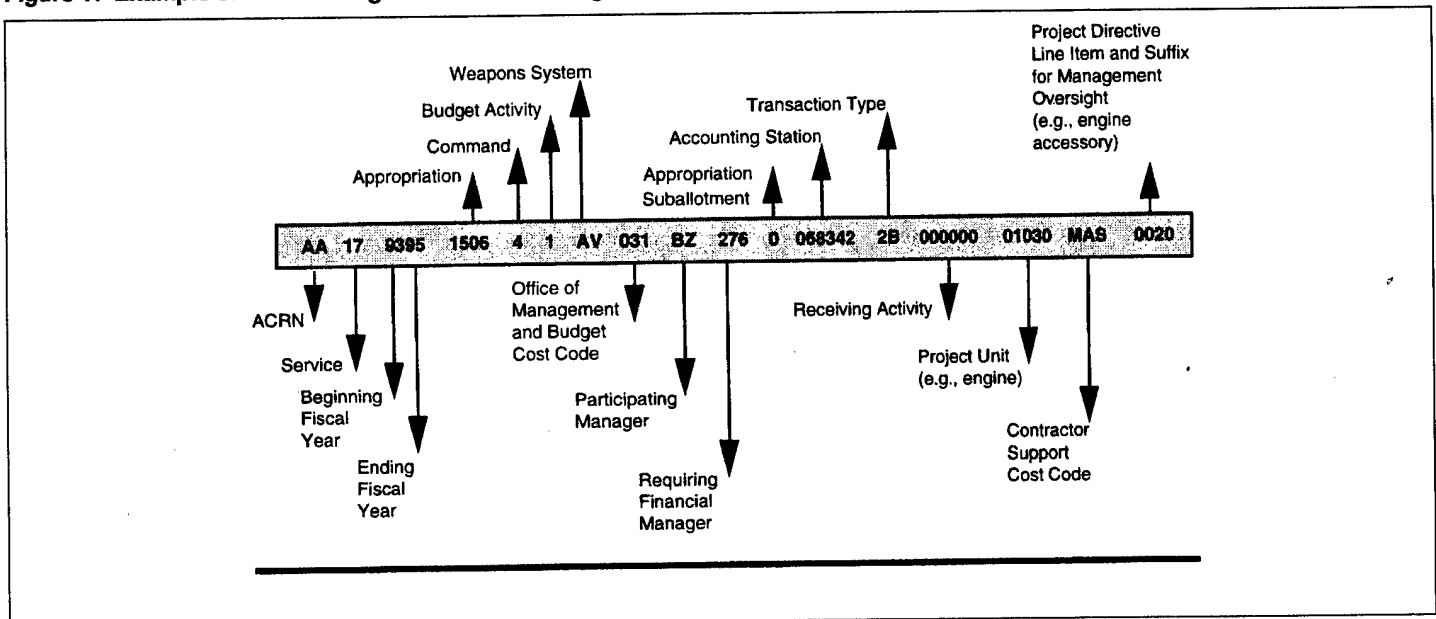
annually in reduced processing costs. Two key areas where DOD needs to focus its efforts are (1) better using available technology by developing seamless, fully integrated payment systems and (2) streamlining and simplifying, to the extent practical, its payment processes.

Detailed Accounting Requirements Are a Burden on Payment Process

Let me give a few examples of the detailed accounting requirements that DFAS payment personnel are faced with when paying a bill. These examples clearly suggest the need for simplification.

DOD uses what is called a "long line of accounting" to accumulate appropriation, budget, and management information for contract payments. For all contracts, the buying activity assigns a two-character code called an accounting classification reference number (ACRN) to each accounting line containing unique information. Figure 1 is an example of an accounting line—the type and quantity of information varies among the services.

Figure 1: Example of DOD's Long Line of Accounting



Source: DOD.

Contracts can be assigned anywhere from 1 to over 1,000 ACRNs. A contract with numerous ACRNs may involve extensive data entry, increasing the chance for errors and manual payment processing. Manual payment processing costs an average of \$15 per ACRN, according to a consulting firm's study.

Payment allocations to numerous ACRNs can be time consuming and may not provide useful or reliable management information. For example, in one case we reviewed, a single payment on a contract with many ACRNs took 6 to 8 hours to process. The contractor, required to bill by ACRN, took 487 pages to assign \$2.1 million in costs and fees to 267 ACRNs. Ten of the ACRNs cited by the contractor had insufficient obligation balances to cover the payment, according to DFAS records. The remaining 257 ACRNs corresponded to 8 annual appropriations covering from 1 to 5 fiscal years and included Army, Air Force, and general defense funds. Of the 257 transactions processed, 38 were for less than \$10, and some involved debits or credits for pennies. Unresolved discrepancies, such as insufficient funds on some ACRNs, have persisted for about 3 years.

Even for a simple purchase, assigning numerous ACRNs can cause extensive and costly rework and provide information of questionable management value. For example, a \$1,209-Navy contract for children's toys, candy, and holiday decorations for a child care center was written with most line items (e.g., bubble gum, tootsie rolls, and balloons) assigned a separate ACRN. A separate requisition number was generated for each item ordered, and a separate ACRN was assigned for each number. In total, the contract was assigned 46 ACRNs to account for contract obligations against the same appropriation. To record this payment against the 1 appropriation, DFAS had to manually allocate the payment to all 46 ACRNs. Figure 2 is an actual portion of this contract showing the ACRNs assigned to each item.

Figure 2: Contract Excerpt

ITEM NO.	SUPPLIES OR SERVICES	QUANTITY ORDERED	UNIT	UNIT PRICE \$	AMOUNT \$
0025	HALLOWEN PINBALL GAME - FA380 Accounting and Appropriation Data: BF 1751805 61C0 548 62585 0 062863 2D SRK001 PPO05026K179 PR #: N62585-5026-K179	5.00	DZ	1.750000	8.75
0026	PUMPKIN BANK - BR28 Accounting and Appropriation Data: BG 1751805 61C0 548 62585 0 062863 2D SRK001 PPO05026K180 PR #: N62585-5026-K180	5.00	DZ	9.500000	47.50
0027	DINOSAUR PENCIL TOPS - 1545L Accounting and Appropriation Data: BK 1751805 61C0 548 62585 0 062863 2D SRK001 PPO05026K181 PR #: N62585-5026-K181	5.00	DZ	1.500000	7.50

Source: DOD.

The contract was modified three times—twice to correct funding data and once to delete funding for out-of-stock items. The modification deleting funding did not list all of the affected ACRNs. DFAS personnel made errors in both entering and allocating payment data, compounding errors made in the modification. Consequently, DFAS allocated payment for the toy jewelry line item to fruit chew, jump rope, and jack set ACRNs—all of which should have been deleted by the modification. Contract delivery was completed in March 1995, but payment was delayed until October 1995. DFAS officials acknowledged that this payment consumed an excessive amount of time and effort when compared to the time to process a payment charged to only one ACRN. The contract could have been assigned a single ACRN, according to a Navy official, thus making it easier to pay without losing useful information. A single ACRN would also have significantly reduced the amount of data entered into the system and the opportunities for errors.

User requirements for detailed accounting place unreasonable or unachievable demands on the payment system. Moreover, DOD's current pricing structure does not reflect the time it takes DFAS to meet user

requirements. Thus, the user has little incentive to critically evaluate the level of detail being required and its associated costs.

DOD Is Taking Actions to Address Payment Problems

DOD is taking steps to address its payment problems. Its initiatives include testing and adopting some best practices. In the long term, it is developing procurement and payment systems that will be linked by sharing common data. This linkage is expected to allow one-time entry of contract data critical to making correct payments. In the meantime, DOD is enhancing its current technologies to further automate the payment process. It is also testing streamlined payment practices and making efforts to reduce the number of contract fund citations. But, as we point out in our January 1999 recent high-risk report,⁵ it will be many years before DOD gets its payment problems under control.

Additional Steps Could Be Taken

Recognizing DOD's actions and the fact that DOD continues to overpay its contractors, one question is: are there additional steps that DOD might take to improve the process for both identifying and collecting overpayments? The answer is yes.

First, we believe that defense contractors should be required to promptly notify the government of overpayments when they become aware of them. This seems simple enough, but currently a contractor is not required to return an overpayment until the government becomes aware of the overpayment and issues a demand letter for repayment. And, as pointed out earlier, the true magnitude of contractor retention of overpayments is not known. In this regard, we will shortly begin a review to assess the extent to which defense contractors are retaining and not promptly returning overpayments to the government.

Second, we believe that DOD should take advantage of best practices that commercial companies use to identify and recover overpayments. One such practice is the use of recovery auditing procedures. For both private industry and government agencies, some payments are processed incorrectly for a variety of reasons. For instance, vendors make pricing errors on their invoices, forget to include discounts that have been publicized to the general public, neglect to offer allowances and rebates, or miscalculate freight charges. Government payment activities may also

⁵Major Management Challenges and Program Risks, Department of Defense (GAO/OCG-99-4, Jan. 1999).

neglect to take discounts to which they are entitled. These mistakes, when not caught, result in overpayments. Identifying and recovering overpayments is referred to as recovery auditing.

Recovery Auditing Offers Potential to Identify Overpayments

Recovery auditing started about 30 years ago, and it is used in several industries, including the automobile, retail store, and food service industries. Within DOD, the Army and the Air Force Exchange Service, and the Navy Exchange Service use recovery auditing. An external audit recovery group may be the only group used by an organization or it may be used in combination with an internal group that examines invoices for overpayments prior to an external group's review.

Recognizing its potential value to the government, the Fiscal Year 1996 National Defense Authorization Act required the Secretary of Defense to conduct a demonstration program to evaluate the feasibility of using recovery auditing to identify overpayments made to vendors by DOD. Authority to expand the program was provided in the Fiscal Year 1998 National Defense Authorization Act.

The DOD demonstration program began in September 1996, when the Defense Supply Center, Philadelphia (DSCP), competitively contracted with Profit Recovery Group International (PRGI). The contract covers purchases made during fiscal years 1993-95 and requires PRGI to identify and document overpayments and to make recommendations to reduce future overpayments. PRGI receives a fee of 20 percent of net collected funds.

In our review of the demonstration program, we concluded that recovery auditing offers potential to identify overpayments but implementation problems hindered DOD from fully realizing the benefits of the program.⁶ As of August 1998, PRGI had identified \$19.1 million in overpayments. However, recoveries of overpayments amounted to only \$1.9 million, in large part, because vendors took issue with some of the overpayments. This caused the recovery process to virtually stop for 8 months while DSCP reviewed the merits of the vendors' issues. DSCP has concluded that the claims of overpayment are valid. However, according to the contracting officer, his letter of final decision regarding vendors' indebtedness has not

⁶Contract Management: Recovery Auditing Offers Potential to Identify Overpayments (GAO/NSIAD-99-12, Dec. 3, 1998).

been issued. PRGI continues to identify overpayments. As of June 1999, according to PRGI, it had identified \$29.3 million in overpayments, and collections by DOD amount to \$2.6 million.

PRGI has also made recommendations to DFAS and DSCP to reduce future overpayments, but, at the time of our review, DOD had not implemented them. In addition, PRGI identified about \$1.8 million in overpayments that were outside the scope of its contract, either because they were not within the contractual review period or because they involved other government agencies. Neither DFAS nor DSCP chose to pursue payment recovery or inform the other government agencies of the overpayments so that they could pursue recovery and take steps to avoid future overpayments.

DOD Is Slow to Use Recovery Auditing Techniques

DOD has been slow to embrace recovery auditing. For example, in House Report 105-532, which related to a bill providing for fiscal year 1999 DOD authorizations, DOD was directed to use recovery auditing by selecting at least two commercial functions within its working capital fund and issuing a competitive request for proposal by December 31, 1998. We found, however, that DOD had not done either.⁷ While DOD issued an August 1998 memorandum encouraging the use of recovery auditing, and some activities have expressed interest, no contracts had been awarded at the time we completed our work in March 1999. In June 1999, we checked with the recipients of the August 1998 memorandum and, with the exception of the U.S. Transportation Command, which told us it just entered into a contract for recovery auditing services, no other contracts have been let. The Defense Commissary Agency said it has completed a statement of work, and plans to have a contract by July 30, 1999. The Defense Logistics Agency told us it issued a solicitation on May 28, 1999, to expand the use of recovery auditing from the demonstration program in place at DSCP to its other four supply centers. The Defense Logistics Agency said it plans to have a contract by August 31, 1999. Each of the services and the Defense Information Services Agency also expressed an interest in recovery auditing and they are evaluating whether to use it.

⁷Contract Management: DOD Is Examining Opportunities to Further Use Recovery Auditing (GAO/NSIAD-99-78, Mar. 17, 1999).

Issues Related to Using Recovery Auditing

While we believe that recovery auditing could be beneficial to DOD and other federal agencies, there are some important implementation issues that need to be considered as federal agencies evaluate using recovery auditing to identify and recover overpayments. First, it is not clear how DOD agencies should organize to perform recovery auditing. Should it be contracted out? Should it be performed with in-house personnel? Should some combination of the two be used? We believe that agencies need to carefully consider the extent to which recovery auditing is applicable to their operations and, if applicable, if it would be cost-effective to undertake moderate internal recovery auditing efforts to pick the "low hanging fruit" before turning audit recovery efforts over to an external group.

Second, it is important that there be (1) periodic reporting by those performing recovery auditing on the factors causing overpayments and on recommendations to reduce overpayments and (2) a process to evaluate these recommendations and implement those that make sense. One of the criticisms we made of the demonstration program was that DOD did not implement the contractor's recommendations to reduce overpayments.

These issues have been addressed in the "Government Waste Corrections Act of 1999" (H.R. 1827), introduced on May 17, 1999, by Congressmen Burton, Arney, and Ose. We believe the bill is a positive step in the government's effort to reduce overpayments and to obtain timely identification and recovery of overpayments when they occur.

Prompt Payment Act Issues

Mr. Chairman, you also asked us for our views on how the Prompt Payment Act could be improved to support DOD's efforts to reduce the risk of overpayments.

The Prompt Payment Act of 1982, as amended, provides governmentwide guidelines for establishing due dates on commercial invoices and paying interest on invoices paid late. Except where otherwise specified within contracts, the act provides that agencies should pay within 30 days after the designated office receives the vendor invoice or the government accepts the items ordered as satisfactory, whichever is later. The act also states that if a payment is late, a business concern shall be entitled to any interest penalty of \$1 or more from the government (interest penalties of less than \$1 are not required to be paid).

In a report we issued in May 1997,⁸ we stated that small interest payments made by the DFAS Columbus Contract Entitlement Directorate comprised a large portion of the number of payments made but accounted for a very small portion of the total interest dollars paid. For example, of the 47,773 interest payments in fiscal year 1996, 10,789, about one quarter of all interest payments, were for \$5 or less, and totaled \$28,701—less than one quarter of 1 percent of total interest payment dollars. Interest payments up to \$25 comprised over 50 percent of all interest payments but less than 2 percent of total interest dollars paid.

DOD officials said that the current minimum payment of \$1 might need to be increased because the benefits from such small interest payments may not justify the costs of making the payments. According to DOD, it takes an average of 45 minutes to process each interest payment at DFAS, Columbus, and that the time spent processing such payments could be better spent on other high priority tasks.

We recently obtained updated information on the interest payments made by the DFAS Columbus Contract Entitlement Directorate under the act. This information shows that in fiscal year 1998, the directorate issued 23,355 checks totaling \$15 million in interest payments to defense contractors. Thirty-eight percent were for payments of \$25 or less. According to the Contract Entitlement Directorate, its cost to process an interest payment check in fiscal year 1998 was at least \$24. DFAS issues a separate check for interest payments.

Through the first half of fiscal year 1999, the DFAS Columbus Contract Entitlement Directorate issued 30,781 checks totaling \$16.6 million in interest for late payments. About 41 percent of these checks representing less than 1 percent of the dollars were for \$25 or less. According to directorate personnel, the increase in interest payments is due to a priority initiative to reduce the backlog of late payments.

Given the cost of processing an interest payment check, it might be cost-effective to increase the minimum dollar requirement for paying interest under the act. Alternatively, the late payment interest could be included in the same check with the principal payment, which would significantly reduce the costs of processing interest payments. We believe

⁸Financial Management: The Prompt Payment Act and DOD Problem Disbursements (GAO/AIMD-97-71, May 23, 1997).

that any initiative to change the minimum interest payment should consider the efficiency of agency payment processes.

Conclusions

In closing, Mr. Chairman, DOD needs to achieve more effective control over its payment process. If DOD does not, it will continue to risk erroneously paying contractors hundreds of millions of dollars and perpetuating other financial management and accounting control problems.

Recovery auditing, which has a long-standing track record in the private sector, offers a low-risk opportunity to identify overpayments and to recover them and we are supportive of the recently introduced legislation to require federal agencies to use recovery auditing.

Currently, contractors are not required to inform the government when they have been overpaid. Contractors should be required to notify the government of overpayments when they become aware of them. Once notified, government contracting personnel should immediately ask contractors to refund the overpayment.

Finally, it may be time to raise the minimum dollar threshold required by the Prompt Payment Act. However, raising the threshold should be part of an overall assessment of the efficiency of the payment process.

Mr. Chairman, this concludes my statement. I will be glad to answer any questions you or the other Members of the Subcommittee may have at this time. Major contributors to this testimony were Daniel J. Hauser and Charles W. Thompson.