
December 1998

CONTRACT MANAGEMENT

Recovery Auditing Offers Potential to Identify Overpayments



**National Security and
International Affairs Division**

B-280221

December 3, 1998

Congressional Committees

The Fiscal Year 1996 National Defense Authorization Act required the Secretary of Defense to conduct a demonstration program to evaluate the feasibility of using private contractors to identify overpayments made to vendors by the Department of Defense (DOD). Authority to continue and expand the program was provided in the Fiscal Year 1998 National Defense Authorization Act. The fiscal year 1998 act also directs us to review the results of the program. Specifically, it requires us to (1) assess the success of the methods used to identify overpayments and (2) determine the types of overpayments identified and the amounts recovered. We also identified factors limiting the identification or recovery of overpayments and developed recommendations for improving the process.

Background

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, miscalculate freight charges, and so forth. These mistakes, when not caught, result in overpayments.

Identifying and recovering overpayments is referred to as recovery auditing. Recovery auditing started about 30 years ago, and it is used in several industries, including the automobile, retail store, and food service industries, and within DOD, by the Army and Air Force Exchange Service and the Navy Exchange Service. 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.

The demonstration program began in September 1996, when the Defense Supply Center, Philadelphia (DSCP), competitively contracted with Profit Recovery Group International (PRGI). The contract, which has been extended twice and will end in May 1999, covers purchases made during fiscal years 1993-95. It 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.

DSCP is the Defense Logistics Agency inventory control point that procures subsistence items, clothing and textiles, and medicines and medical supplies for the U.S. Armed Forces and other non-DOD customers, such as the Veterans Administration and Job Corps centers. Payment for the commodities bought by DSCP and covered under the demonstration program are made by the Defense Finance and Accounting Service (DFAS), Columbus, Ohio. DFAS does not typically review these types of items for overpayments.

In late 1997, Congress authorized expansion of the program to other payments managed through the Defense Business Operations Fund and DOD is examining how to implement the congressional direction. In an August 1998 memorandum, the DOD Comptroller encouraged DOD agencies to use recovery auditing as a way to identify and correct payment problems.

Results in Brief

The methods used by the Profit Recovery Group International to perform recovery auditing resulted in the identification of \$19.1 million in overpayments, as of August 14, 1998, and efforts to identify additional amounts continue. However, recoveries of overpayments amounted to only \$1.9 million, in large part, because vendors took issue with some of the overpayments identified by Profit Recovery Group International. This caused the recovery process to virtually stop for 8 months while the Defense Supply Center, Philadelphia reviewed the merits of the vendors' issues. The Defense Supply Center, Philadelphia has concluded that the claims of overpayment are valid, but it has not yet notified vendors of the final decision regarding their indebtedness.

Of \$19.1 million in overpayments, \$12.4 million was related to cash discounts not taken or received or deducted at the wrong rate, \$2.2 million related to most favored customer terms not received, \$1.3 million related to duplicate payments made, and \$1.2 million related to credits for returned merchandise not taken. As of August 14, 1998, according to Profit Recovery Group International, it had audited about 80 percent of the \$7.2 billion audit base.

The fact that the overpayments were made 4 to 6 years before audit recovery began also made overpayment identification or recovery challenging. Documentation was difficult to retrieve for both Profit Recovery Group International and vendors, and sometimes it was not available. The Profit Recovery Group International also had considerable

difficulty identifying duplicate payments because the needed information was not retained in the Defense Finance and Accounting Service payment files. Finally, according to Profit Recovery Group International, even though its contract was awarded in September 1996, it was slow to begin audit work because of delays in obtaining Defense Finance and Accounting Service computerized payment files and the time the Profit Recovery Group International needed to understand DOD's procurement and payment processes.

The Profit Recovery Group International has made recommendations to the Defense Finance and Accounting Service and the Defense Supply Center, Philadelphia to reduce future overpayments, but none have been implemented. In addition, the Profit Recovery Group International identified about \$1.8 million in overpayments that were outside the scope of its contract, either because they were not within the fiscal year 1993-95 contractual review period or because they involved other government agencies. Neither the Defense Finance and Accounting Service or the Defense Supply Center, Philadelphia 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.

Success of the Methods Used to Identify Overpayments

PRGI's methodology involves four key steps. These steps are (1) understand the procurement and payment processes for all transactions; (2) identify the data needed to establish an audit trail, such as purchase orders/agreements, paid history files, invoices, receiving information, vendor term files, and data from procurement files, such as price lists, promotional allowances, and volume allowances; (3) examine the data using proprietary software to identify missed discounts, price discrepancies, duplicate payments, and other overpayments; and (4) generate a hard copy claim, with supporting documentation, for each potential overpayment.

In applying this methodology to DFAS payments, PRGI initially focused on identifying missed discounts and price discrepancies. PRGI compared cash discounts and prices offered to commercial customers to the cash discounts offered to and prices paid by DSCP. It also sent letters to vendors requesting current statements of their accounts with DSCP. Between March 1997 and July 1998, two separate mailings were made asking vendors to provide statements of their accounts. About 20 percent of the vendors responded, resulting in the recovery of \$1.2 million. One recovery

of \$957,000 related to the recall of a withdrawn immunization serum for which DOD had not taken credit.

As of August 14, 1998, according to PRGI, it had audited about 80 percent of the \$7.2-billion audit base and identified about \$19.1 million in overpayments. Table 1 shows the types and amounts of overpayments identified by PRGI and recovered by DOD.

Table 1: Types and Amounts of Overpayments Identified and Recovered as of August 14, 1998

Type	Identified	Recovered
Cash discounts		
1) Not offered (Discount not offered DSCP but offered to commercial customers.)	\$7,477,454	\$15,840
2) Earned but not taken (DFAS payment system did not override cash discount terms specified in contract with more liberal terms specified in invoice.)	4,346,307	34,266
3) Deducted at wrong rate	561,731	38,423
Subtotal	\$12,385,492	\$88,529
Overcharge by comparison (Vendor charged DSCP more than its most favored customer.)	2,170,909	6,708
Duplicate payment	1,283,088	246,820
Unposted credit memorandum (As a result of returned merchandise, vendor sent a credit memo that remained outstanding.)	1,174,748	1,171,514
Accounting error	377,866	281,182
Unapplied payment (Payment that the vendor cannot match to an invoice.)	118,837	72,566
Price protection (Losses to the value of a retailer's inventory, should a vendor reduce prices to other retailers.)	58,571	0
Allowances (The vendor gave financial considerations in exchange for meeting specific requirements, such as advertising or promotional sales.)	13,755	0
Interest paid in error	8,681	2,866
All other errors	500	500
Shortage discrepancy (Vendor sent less than the quantity ordered.)	421	421
Pending claims (Written, not yet approved by DSCP.)	1,512,535	0
Total	\$19,105,403	\$1,871,106

Source: PRGI.

Factors Limiting the Identification or Recovery of Overpayments

A number of factors have inhibited the identification or recovery of overpayments. Foremost, vendors disagreed with DSCP claims that it did not receive most favored customer status because it was not offered cash discounts offered to commercial customers. As a result, the recovery process was virtually halted for 8 months while DSCP reviewed the basis of the vendors' claims. In addition, because of the time between the purchases by DSCP (fiscal years 1993-95) and the audit recovery (fiscal years 1997-98), both PRGI and the vendors had difficulty finding supporting documentation. PRGI also had considerable difficulty identifying potential duplicate payments because its proprietary software was incompatible with the payment systems. Finally, according to PRGI, even though the contract was awarded in September 1996, PRGI could not begin audit work in earnest until June 1997, due to delays in obtaining computerized payment files. This, in combination with the time required to become knowledgeable of DSCP procurement processes and DFAS payment systems, delayed the progress of the demonstration program.

Vendors Disagreed With Claims and Process

Certain subsistence vendors are designated brand name suppliers because only the vendors' products are specified for procurement, precluding competition. This practice is authorized for purchases of products bought by DSCP and resold to other government agencies, such as the Defense Commissary Agency. In short, a brand name product is a product desired or preferred by a customer. Kellogg's Corn Flakes is an example of a brand name product.

Because there is no competition, brand name contracts require that all prices offered the government be as advantageous as the prices offered the vendor's most favored customer. This provision expressly includes quantity discounts, allowances, rebates, special promotions, and billing advantage. PRGI interpreted the term billing advantage to mean that vendors are required to offer the government cash discounts for prompt payment similar to those offered the vendor's most favored customer. PRGI identified cases where the government was not offered the same "billing advantage," or discount for prompt payment, as was offered the vendor's most favored customer. As a result, claims were written against vendors for cash discounts not offered.¹ For example, according to PRGI, one vendor routinely offered a 2-percent discount to its commercial customers if payment was made within 10 days, but this discount was not offered to

¹Under the Prompt Payment Act of 1982, agencies generally are not to pay earlier than 7 days prior to the due date unless vendors offer a discount for early payment.

the government. As a result, a claim of about \$187,000 was made against this vendor.

As PRGI identified potential overpayments made to brand name subsistence vendors, it sent letters of indebtedness to them. Many vendors protested both individually and through their trade association, the American Logistics Association (ALA). The brand name vendors and the ALA made the following arguments.

- The claims process did not follow the Federal Acquisition Regulation (FAR). Many of the letters of indebtedness were signed by the government contracting officer's representative, and PRGI responded to vendor questions. The vendors and ALA argued that, according to the FAR, only a contracting officer can sign letters of indebtedness and that PRGI should not respond to vendor questions.
- Cash discounts were not offered because, historically, DSCP did not pay its bills within the discount period.
- DOD did receive most favorable customer prices. During the 1993-95 time frame, DSCP contracted for subsistence items that it resold to the Defense Commissary Agency for sale in commissaries in Europe. Even though the prices charged by the vendors to DSCP may not have reflected most favorable customer prices, the vendors and ALA contend that subsequent voluntary price reductions provided by vendors to the Defense Commissary Agency for promotional purposes effectively reduced item costs to most favored customer prices after items were received by the commissaries.

In addition, vendors complained that the tone of the demand letters, which cited interest penalties, automatic offsets within 30 days, and liability for civil and/or criminal prosecution under the False Claims Act, was threatening. They also believed the 30-day time period provided to review claims was unreasonable.

As a result of these concerns, the process of recovering PRGI-identified overpayments was virtually halted. PRGI continued to look for overpayments, but no letters of indebtedness, regardless of the cause, were sent to vendors. DSCP spent the next 8 months reviewing complaints by brand name subsistence vendors. On April 15, 1998, DSCP concluded that the vendors' concerns were not valid. As a result, DSCP decided to pursue the cash discount claims identified by PRGI. However, letters representing the final decision on amounts owed have not been sent to vendors.

Time Between Payment and Audit Recovery Efforts Create Documentation Problems

The time between the years the payments were made by DSCP (fiscal years 1993-95) and the date of the recovery audit (fiscal years 1997-98) made finding supporting documentation difficult for both PRGI and the vendors. In some cases, documentation was unavailable; in others, the vendors needed additional time to locate files.

Although typical recovery auditing occurs within 6 months to a year of a transaction, the legislative mandate required the audit of purchases during the fiscal year 1993-95 time frame, 4 to 6 years before the demonstration program. As a result, PRGI had difficulty obtaining documentation from DFAS. For example, PRGI was unable to verify any fiscal year 1993 transactions from one payment system because supporting documentation, including vendor invoice copies, had been discarded prior to storage. Consequently, the audit base for the demonstration program was reduced from \$8.9 billion to \$7.2 billion.

Because of the age of the payments, some vendors said that their documentation had been sent to storage. Consequently, vendors received up to 90 days to review DSCP's claims of indebtedness.

PRGI Had Difficulty Identifying Duplicate Payments

PRGI had difficulty identifying potential duplicate payments because of limitations with its proprietary software. According to PRGI officials, payments in the private sector are invoice based, and PRGI software was developed based on private sector practices. However, the DOD payment systems do not retain invoice numbers or invoice dates. The DFAS payment systems pay by contract or contract line item number. To compensate for these limitations, PRGI manually sorted through records sent to storage to identify potential duplicate payments. According to PRGI, its proprietary software is being modified to identify duplicate payments given the specialized nature of DFAS payment systems.

Delays in Beginning the Demonstration Program

According to PRGI, even though the contract was signed in September 1996, PRGI did not begin audit work in earnest until June 1997, due to delays in obtaining computerized payment files. Further, PRGI personnel needed time to understand DOD's unique procurement and payment processes, according to PRGI. For example, one payment system contains data on about 384,000 contracts and disburses about \$5.7 billion each month. These affected how quickly PRGI was able to identify overpayments.

Recommendations to Reduce Overpayments Not Implemented

According to the contract, PRGI is required to make recommendations to reduce future overpayments. In November 1997, and again in April 1998, PRGI published interim reports, with recommendations ranging from reprogramming payment systems to providing contracting personnel additional training to help them determine price reasonableness. For example, PRGI recommended that DSCP periodically review all vendor activity by asking vendors the status of their accounts with DSCP. PRGI used this technique and recovered \$957,000 from one vendor. Currently, neither DFAS nor DSCP periodically ask vendors the status of their accounts. PRGI also recommended that additional training be given to contracting personnel to ensure that the types of discounts and allowances available in the private sector are provided to the government. According to PRGI, private sector organizations are able to reduce future overpayments and strengthen payment processes and controls by implementing procedures such as those recommended by PRGI. To date, the recommendations do not appear to have received a critical review and none have been implemented by either DSCP or DFAS.

DFAS claims that recommendations requiring the reprogramming of payment systems to reduce overpayments are not feasible due to funding limitations. Also, DFAS is consolidating its payment systems into one payment system, the Defense Procurement Payment System, and DFAS said that the PRGI recommendations will be incorporated in that system, currently targeted to come on-line in 2002. DSCP said it is waiting until the end of the program before it reviews the feasibility of implementing PRGI recommendations.

Action Not Taken to Recover Potential Out-of-Scope Overpayments

One of PRGI's steps in identifying overpayments was to send letters to DSCP vendors requesting that they provide a statement of their accounts with the government. Vendor responses surfaced an estimated \$1.75 million in overpayments that were outside the scope of the PRGI contract either because they were not within the contractual review period (\$484,000) or the overpayments were related to another government contract (estimated by PRGI to be \$1.27 million).

Both DFAS and DSCP officials said they had not taken action to pursue recovery or to inform the other government agencies so that they could pursue recovery and take steps to avoid future overpayments for a number of reasons. Reasons included not knowing the extent of these overpayments, not having the staff to substantiate their validity, not having

procedures for notifying other federal agencies, and waiting for possible expansion of PRGI's contract beyond the fiscal year 1993-95 time frame.

Conclusions

PRGI, through its methodology, has identified overpayments of \$19.1 million and is continuing its efforts to identify additional overpayments. This magnitude of overpayments would likely not have been identified by DFAS without the demonstration program. However, government efforts to collect these overpayments have been slow—only \$1.9 million has been recovered—largely because the recovery process virtually stopped for 8 months, while DSCP reviewed the merits of the vendors' complaints. While DSCP has concluded the government's claims are valid, it has not yet issued letters notifying vendors of the final decision regarding amounts owed.

There are a number of steps DOD can take to improve its use of audit recovery, particularly as it considers using audit recovery at other DOD activities. For example, DOD can implement some of the PRGI recommendations that do not require costly reprogramming of payment systems and that could preclude future overpayments. It could periodically review all vendor activity by asking vendors the status of their accounts. PRGI used this technique and recovered \$957,000 from one vendor. DOD could also provide additional training to contracting personnel to ensure that the types of discounts and allowances available in the private sector are provided to the government. According to PRGI, private sector organizations are able to reduce future overpayments and strengthen payment processes and controls by implementing procedures such as those recommended by PRGI. Until DOD gives more serious and timely consideration to PRGI's recommendations, it will likely incur the same types of overpayments.

Recommendations

We recommend that the Secretary of Defense direct the Comptroller to:

- Focus future audit recovery efforts on the most recent purchases to maximize the likelihood that government and vendor documentation is available to support overpayment identification and recovery.
- Critically review PRGI's recommendations and implement those that are cost-effective.
- Consider the extent to which it may be cost-effective to undertake moderate internal efforts to identify overpayments before turning audit recovery efforts over to an external group. One technique that DOD might

find cost-effective is to periodically request status of accounts from its vendors.

- Establish a process for dealing with overpayments due other agencies.

Agency Comments and Our Evaluation

In commenting on a draft of this report, DOD concurred with our recommendations. DOD said that DFAS has reviewed PRGI's recommendations to reduce overpayments, and it is in the initial stages of efforts to implement them. As we stated in the report, we believe some of the PRGI recommendations are worthy of immediate consideration, do not require costly reprogramming of payment systems, and if implemented, could reduce future overpayments. We urge DFAS to move quickly to implement these recommendations. (DOD's comments appear in app. I.)

Scope and Methodology

To assess the methods used to identify overpayments, we reviewed PRGI's methodology for determining overpayments and interviewed PRGI, DFAS, and DSCP officials. We also obtained the views of recovery audit users and the vendor community through their trade association, the ALA. To determine the types and total amount of overpayments identified and recovered, we reviewed DFAS and PRGI records.

To develop recommendations for improving the process by which overpayments are recovered by DOD, we reviewed the private sector practices for identifying and recovering overpayments and the recommendations PRGI made, and considered the factors limiting the identification or recovery of overpayments.

We performed our work at the Office of the Secretary of Defense, Washington, D.C.; DFAS Headquarters, Arlington, Virginia; DFAS Columbus, Ohio; the Defense Commissary Agency, Fort Lee, Virginia; the Army and Air Force Exchange Service, Dallas, Texas; the American Logistics Association, Washington, D.C.; Wal-Mart Stores, Incorporated, Bentonville, Arkansas; and the S.C. Johnson Company, Racine, Wisconsin.

We performed our work from March 1998 through November 1998 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Secretary of Defense; the Director of the Office of Management and Budget; the Commander, Defense Logistics Agency; the Director, Defense Finance and Accounting

Service; the Commander, Defense Contract Management Command; and appropriate congressional committees. Copies will also be made available to others on request.

Please contact me at (202) 512-4587 if you or your staff have any questions concerning this report. Major contributors to this report were Charles W. Thompson, Daniel J. Hauser, and Myra W. Butler.

A handwritten signature in black ink that reads "David E. Cooper". The signature is written in a cursive style with a large, prominent initial "D".

David E. Cooper
Associate Director
Defense Acquisitions Issues

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Comments From the Department of Defense

Note: GAO's comment supplementing those in the report text appear at the end of this appendix.



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November 4, 1998

Mr. David E. Cooper
Associate Director, Defense
Acquisitions Issues
National Security and International
Affairs Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Cooper:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report, "CONTRACT MANAGEMENT: Recovery Auditing Offers Potential to Identify Overpayments", dated October 14, 1998 (GAO Code 707315/OSD Case 1709).

The Department of Defense (DoD) concurs with the recommendations of the draft report. The GAO examined a demonstration project established to evaluate the feasibility of using private contractors to identify overpayments made to vendors. The demonstration project began in September 1996, when the Defense Supply Center, Philadelphia (DSCP) competitively contracted with Profit Recovery Group International (PRGI), and it is still ongoing. Pages 5 and 13 of the subject draft report indicate that DSCP and the Defense Finance and Accounting Service (DFAS) have not implemented specific PRGI recommendations. Because the demonstration project is a work in process, we recommend that the draft audit acknowledge that both DSCP and DFAS have reviewed PRGI's recommendations and are in the initial stages of efforts to implement them.

The draft report also acknowledges that many of the potential overpayments identified by PRGI have not been recovered because they have been contested by the affected vendors, who base their objections on various laws and regulations. Consequently, the DoD recommends that GAO's planned follow-on expansion of this audit (GAO Code 707387) discuss whether there are any impediments in law or regulation to the government's adoption of commercial audit recovery practices.



See comment 1.

Appendix I
Comments From the Department of Defense

Thank you for the opportunity to comment on the subject draft report.

Sincerely,

A handwritten signature in black ink that reads "Eleanor R. Spector". The signature is written in a cursive style with a large, prominent "E" and "S".

Eleanor R. Spector
Director, Defense Procurement

The following are GAO's comments on the Department of Defense's (DOD) letter dated November 4, 1998.

GAO Comments

1. DOD recommends that our planned follow-on expansion of this audit discuss whether there are any impediments in law or regulation to the government's adoption of commercial audit recovery practices. We are in the planning stages of the follow-on assignment and will consider DOD's recommendations as we plan our audit work.

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