

November 2007

# CENTERS FOR MEDICARE AND MEDICAID SERVICES

## Internal Control Deficiencies Resulted in Millions of Dollars of Questionable Contract Payments





Highlights of [GAO-08-54](#), a report to congressional requesters

## Why GAO Did This Study

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA) established a voluntary outpatient prescription drug benefit, which is administered by the Centers for Medicare and Medicaid Services (CMS). CMS relies extensively on contractors to help it carry out its basic mission. Congress appropriated to CMS \$1 billion for start-up administrative costs to implement provisions of MMA. Because CMS had discretion on how to use the appropriation, Congress asked GAO to determine (1) how CMS used the \$1 billion MMA appropriation, (2) whether CMS's contracting practices and related internal controls were adequate to avoid waste and to prevent or detect improper payments, and (3) whether payments to contractors were properly supported as a valid use of government funds. To address objectives two and three above, our review extended beyond contract amounts paid with MMA funds.

## What GAO Recommends

GAO makes nine recommendations to improve internal control and accountability in the contracting process and related payments to contractors. In written comments on a draft of this report, CMS stated that it would take action on each of our recommendations and described some steps taken and others planned to address our recommendations. At the same time, CMS disagreed with some of our findings. We continue to believe that our findings fully support our nine recommendations.

To view the full product, including the scope and methodology, click on [GAO-08-54](#). For more information, contact Jeanette Franzel at (202) 512-9471 or [franzelj@gao.gov](mailto:franzelj@gao.gov).

# CENTERS FOR MEDICARE AND MEDICAID SERVICES

## Internal Control Deficiencies Resulted in Millions of Dollars of Questionable Contract Payments

### What GAO Found

CMS expended over 90 percent of the MMA appropriation by the end of December 2006. The majority, about \$735 million, was paid to contractors and vendors for a variety of services. For example, because the volume of calls to the 1-800-MEDICARE help line significantly increased with the new outpatient prescription drug benefit, two contractors were paid about \$234 million to support the help line. CMS also made payments to other federal agencies for services such as printing and mailing; to state agencies to fund educating the public; for CMS employee payroll and travel costs; and for purchase card transactions to acquire office supplies, equipment, and outreach materials.

CMS management has not allocated sufficient resources, both staff and funding, to keep pace with recent increases in contract awards and adequately perform contract and contractor oversight. This operating environment created vulnerabilities in the contracting process. Specifically, CMS did not adequately fulfill critical contractor oversight, such as working with contractors to establish indirect cost rates. Further, certain contracting practices, such as the frequent use of cost reimbursement contracts, increased risks to CMS. After contract award, pervasive internal control deficiencies increased the risk of improper payments. Because CMS did not have clear invoice review guidance, invoice review procedures were often flawed or did not take place. CMS also had not taken steps to ensure contracts were closed within required deadlines and had a backlog of approximately 1,300 contracts as of September 30, 2007.

GAO identified numerous questionable payments totaling nearly \$90 million. These payments were for costs not compliant with contract terms, which could be potentially improper; costs for which we could not obtain adequate support to determine whether the costs were allowable; and potential waste caused by risks in CMS's contracting practices. Importantly, in some cases, because we were not able to determine whether or to what extent the costs were allowable, some of the questioned amounts may relate to allowable costs that are not recoverable. The table below summarizes the questionable payments GAO identified.

### Summary of Questionable Payments

Dollars in millions	
Type of questionable payment	Amount
Costs not compliant with contract terms and regulations	\$24.5
Unsupported contractor costs	62.7
Potential waste	6.6
Less overlapping amounts <sup>a</sup>	(5.0)
<b>Total</b>	<b>\$88.8</b>

Source: GAO analysis of contractor invoices and data.

<sup>a</sup>In certain instances, a portion of a questionable payment may fall into more than one category (i.e., a payment may be both potential waste and not compliant with contract terms). Therefore, to avoid double counting questionable payment amounts, we reduced the gross questionable payment amount by the overlapping amount (\$5.0 million).

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**Abbreviations**

BAH	Booz Allen Hamilton
CAS	Cost Accounting Standards
CMS	Centers for Medicare and Medicaid Services
DCAA	Defense Contract Audit Agency
DOD	Department of Defense
FAR	Federal Acquisition Regulation
FTE	full time equivalents
GSA	General Services Administration
HHS	Department of Health and Human Services
HHSAR	Health and Human Services Acquisition Regulations
IBM	International Business Machines
IFMC	Iowa Foundation for Medical Care
IR&D	independent research and development
IT	information technology
MMA	Medicare Prescription Drug, Improvement, and Modernization Act of 2003
NIH	National Institutes of Health
OAGM	Office of Acquisition and Grants Management
OFM	Office of Financial Management
OIG	Office of Inspector General
SBA	Small Business Administration
T&M	time and materials

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United States Government Accountability Office  
Washington, DC 20548

November 15, 2007

The Honorable Max Baucus  
Chairman  
The Honorable Charles E. Grassley  
Ranking Member  
Committee on Finance  
United States Senate

In the most significant change to the Medicare program since its inception, the Medicare Prescription Drug, Improvement, and Modernization Act of 2003<sup>1</sup> (MMA) established a voluntary outpatient prescription drug benefit, known as the Part D benefit. This benefit, which became available in January 2006, is intended to help seniors and persons with disabilities pay for outpatient prescription drugs. The Centers for Medicare and Medicaid Services (CMS) is the agency within the Department of Health and Human Services (HHS) that administers the Medicare program and Part D benefit. CMS relies extensively on contractors to carry out its basic mission. For example, the contractors that process and administer medical claims have played a critical role in serving both Medicare beneficiaries and health care providers. During fiscal year 2006, CMS awarded contracts valued at \$3.8 billion.

Congress appropriated to CMS \$1 billion for start-up administrative costs to implement MMA provisions. These MMA funds were available for obligation<sup>2</sup> through September 2006. Because CMS was granted broad discretion on how to use the appropriation, you asked us to determine (1) how CMS used the \$1 billion MMA appropriation (2) whether CMS's contracting practices and related internal controls were adequate to avoid

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<sup>1</sup> Pub. L. No. 108-173, 117 Stat 2066 (Dec. 8, 2003).

<sup>2</sup> An obligation is a definite commitment that creates a legal liability of the government for the payment of goods and services ordered or received. Payment may be made immediately or in the future.

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waste<sup>3</sup> and to prevent or detect improper payments,<sup>4</sup> and (3) whether payments to contractors were properly supported as a valid use of government funds.

To address these objectives, we analyzed CMS obligation information and disbursement information from January 2004 through December 2006; discussed this information with CMS officials; and assessed contracts, interagency agreements, and related supporting documentation, including statements of work, vendor invoices, and contract files. We also interviewed CMS officials about their contractor oversight responsibilities and analyzed relevant CMS policies, procedures, and training. We used GAO's standards for internal control<sup>5</sup> and Federal Acquisition Regulation (FAR)<sup>6</sup> requirements as a basis to assess CMS's contracting practices and related internal controls. We selected contractors and contracts<sup>7</sup> to test based on amounts paid with MMA funds and other risk factors. We performed data mining<sup>8</sup> and forensic auditing<sup>9</sup> techniques to select specific contract transactions for detailed testing. Specifically, for these selected transactions, we analyzed additional supporting documentation obtained from contractors and discussed billed amounts with contractor officials.

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<sup>3</sup> Waste involves the taxpayers in the aggregate not receiving reasonable value for money. Importantly, waste involves a transgression that is less than fraud and abuse. Most waste does not involve a violation of law or regulation but rather relates to mismanagement or inadequate oversight.

<sup>4</sup> Improper payments include duplicate payments and miscalculations; payments for goods or services not rendered; payments resulting from fraud or abuse; or payments for unallowable costs (contractor costs that are not allowed under a term or condition of the contract or pursuant to applicable regulation).

<sup>5</sup> GAO, *Standards for Internal Control in the Federal Government*, [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: November 1999).

<sup>6</sup> 48 C.F.R. ch. 1.

<sup>7</sup> For the purposes of this report, the term "contract" is generally used to refer to both contracts and task orders issued under contracts. We use the term "task order" when we discuss an issue or a requirement that applies just to a task order and not to the underlying contract.

<sup>8</sup> Data mining applies a search process to a data set, analyzing for trends, relationships, and associations. For instance, it can be used to efficiently query transaction data for characteristics that may indicate potentially improper activity.

<sup>9</sup> Forensic auditing refers to techniques used to apply increased scrutiny to the facts and circumstances (including judgments made and actions taken by individuals party to the transaction) surrounding potentially fraudulent, improper, and abusive transactions.

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While we identified instances of questionable payments,<sup>10</sup> our work was not designed to identify all questionable payments or to estimate their extent. Because CMS funded some invoices with funding sources in addition to MMA, the questionable payments we identified may not be solely associated with the MMA appropriation.

Appendix II provides additional details of our scope and methodology. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. We conducted our audit work in Washington, D.C. and Baltimore, Maryland from March 2006 through September 2007.

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## Results in Brief

Congress appropriated to CMS \$1 billion for start-up administrative costs to implement MMA provisions. CMS obligated all of the funding made available by MMA and expended over 90 percent of it by the end of December 2006. The majority, about \$735 million, was paid to contractors and vendors for a variety of services, including information technology (IT), support for the 1-800-MEDICARE help line, and outreach and education for the prescription drug benefit. CMS also made payments to other federal agencies for services such as printing and mailing; to state agencies to help fund educating the public about the new prescription drug benefit; for CMS employee payroll and travel costs; and for purchase card transactions to acquire office supplies, equipment, and outreach materials.

CMS management has not allocated sufficient resources, both staff and funding, to keep pace with recent increases in contract awards and adequately perform contract and contractor oversight. This operating environment created vulnerabilities in the contracting process. Specifically, CMS did not fulfill critical contractor oversight responsibilities, such as reviewing contractors' indirect cost rate

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<sup>10</sup> Questionable payments include payments for costs that we determined to be potentially unallowable or lack the support necessary to determine whether they are allowable under applicable laws, regulations, and the terms and conditions of the contract. Questionable payments also include payments for which we had concerns that risks in CMS's contracting practices resulted in potential waste.

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information and assessing the adequacy of the contractors' accounting systems, thereby increasing risks not only to CMS but to other federal agencies that may use the same contractors. Additionally, risks in CMS's contracting practices made CMS vulnerable to waste. For example, CMS did not always benefit from the effects of competition when awarding contracts. Further, CMS frequently used a contract type—cost reimbursement—under which the government assumes most of the cost risk. In some cases, this contract type was used contrary to FAR requirements. After contract award, pervasive internal control deficiencies in the contracting process increased the risk of improper payments. For example, CMS often used flawed procedures to review and approve invoices in part because policies, procedures, and training provided inadequate guidance to key staff. Meanwhile, other CMS procedures allowed for the payment of an invoice whether or not the invoice was reviewed and approved. Additionally, CMS had not taken steps to ensure contracts were closed within required deadlines and had a backlog of approximately 1,300 contracts needing closeout as of September 30, 2007.

We identified numerous questionable payments totaling nearly \$90 million that represent potentially improper, unsubstantiated, or wasteful payments. For example, we found payments for costs that did not comply with the terms of the contract or applicable regulation, such as costs for unapproved labor categories, costs exceeding contract ceiling amounts, and travel costs in excess of allowable limits. In other cases, we were unable to obtain adequate documentation, such as vendor invoices or time sheets, to support costs billed. In addition, we identified payments for which risks in CMS's contracting practices resulted in potential waste. In some cases, due to the facts and circumstances involved, we were unable to determine whether or to what extent the costs were allowable, reasonable, and allocable. As a result, some portion of the total amount of questionable payments we identified ultimately may be determined by CMS to be allowable and therefore not recoverable from the contractor. Given CMS's poor control environment and the fact that our work was not designed to identify all questionable payments made by CMS or to estimate their extent, other questionable payments may have been made.

To improve internal control and accountability in the contracting process and related contract payments, we are making nine recommendations to the Administrator of CMS to develop additional policies and procedures, training on the invoice review process, and a plan to reduce the backlog of contracts awaiting closeout.



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In written comments on a draft of this report, CMS stated that it would take action on each of our recommendations and described steps taken and others planned to address our recommendations. At the same time, CMS disagreed with some of our findings. Specifically, CMS disagreed with the questionable payments identified in our report. However, CMS also stated that it has not yet performed audits of the contracts in question. Our report clearly states that in some cases, due to the facts and circumstances involved, we were unable to determine whether or to what extent the costs we questioned were allowable, reasonable, and allocable. As a result, some portion of the total amount of questionable payments we identified ultimately may be determined by CMS to be allowable. However, we also state that given CMS's poor control environment and the fact that our work was not designed to identify all questionable payments made by CMS or to estimate their extent, other questionable payments may have been made. We continue to believe that our findings fully support the nine recommendations we make for improved control and accountability over the contracting process and related payments. However, we have considered CMS's comments and have incorporated, as appropriate, clarifying language in our report.

Our responses to CMS's comments are provided in the agency comments section of this report and in appendix III, immediately following the reprinted CMS comments.

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## Background

Contracts of federal executive agencies that use appropriated funds are administered in accordance with laws,<sup>11</sup> FAR, agency-specific FAR supplements, the Cost Accounting Standards (CAS),<sup>12</sup> and the terms of the contract. HHS' FAR supplement, the Health and Human Services Acquisition Regulations (HHSAR),<sup>13</sup> contains additional requirements not found in the FAR, such as disallowing payments to contractors for

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<sup>11</sup> Subch. IV of ch. 4 of title 41, United States Code.

<sup>12</sup> 48 C.F.R. ch. 99. These standards are mandatory for use by all executive agencies and by contractors and subcontractors in estimating, accumulating, and reporting costs in connection with pricing and administration of, and settlement of disputes concerning, all negotiated prime contract and subcontract procurements with the U.S. government in excess of \$500,000. Certain contracts or subcontracts are exempt from CAS, such as those that are fixed price or those with a small business. Additionally, contractors that received less than \$50 million in net awards in the prior accounting period are subject to only certain CAS standards, known as modified coverage.

<sup>13</sup> 48 C.F.R. ch. 3.

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independent research and development costs.<sup>14</sup> The purpose of CAS is to help achieve uniformity and consistency in contractors' cost accounting practices and provide rules for estimating, accumulating, and reporting costs under government contracts and subcontracts. For example, CAS requires certain contractors to prepare a disclosure statement that describes their accounting practices and requires that similar costs be treated in the same manner. Contractor compliance with CAS is monitored by a contractor's cognizant federal agency.<sup>15</sup>

The cognizant federal agency is usually the agency with the largest dollar amount of negotiated contracts, including options, with the contractor. To help ensure continuity and ease of administration, FAR recommends that once an agency assumes cognizant federal agency responsibilities for a contractor, it generally retains cognizant status for at least 5 years. If, at the end of the 5-year period, another agency has the largest dollar amount of negotiated contracts including options, the two agencies coordinate and determine which one will assume the responsibilities. In addition to monitoring CAS compliance, the cognizant federal agency is responsible for determining if the contractor's billing and accounting systems are adequate to record and bill costs in accordance with FAR.<sup>16</sup> The cognizant federal agency also establishes provisional indirect cost rates<sup>17</sup> based on an audit of information provided by the contractors that contractors use to estimate indirect costs on their invoices. The cognizant federal agency also establishes final indirect cost rates based on an audit of actual costs of the contractor during the year. The final indirect cost rates are used to adjust contractor billings (based on provisional indirect cost rates) for actual costs and may result in an additional cost or savings to the government. The final indirect cost rates established by the cognizant federal agency are utilized by agencies dealing with the contractor. Because other agencies rely on this cost information and oversight, it is particularly important that the cognizant federal agency fulfills its responsibilities.

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<sup>14</sup> 48 C.F.R. 352.216-72(b)(3).

<sup>15</sup> 48 C.F.R. 2.101.

<sup>16</sup> 48 C.F.R. 2.101, 30.202-7, 42.003, 42.101(a)(2), and 9903.202-6.

<sup>17</sup> 48 C.F.R. 2.101. An indirect cost rate is the percentage or dollar factor that is used to allocate costs not directly identified with a single final cost objective, such as a contract. Employee fringe benefits, general and administrative costs, and overhead are examples of indirect cost rates.

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MMA significantly changed Medicare law covering CMS's contracting for Medicare claims administration services. CMS refers to these changes, which are intended to improve service to beneficiaries and health care providers, as Medicare contracting reform. The implementation of contracting reform, which CMS is required to complete by October 2011, will fundamentally change Medicare claims administration contracting practices. Specifically, MMA requires CMS to use competitive procedures to select Medicare Administrative Contractors (formerly referred to as claims administration contractors) and to follow FAR except where specific MMA provisions differ. Prior to MMA, CMS was generally exempt from these requirements for its claims administration contractors. According to data provided by CMS's Office of Acquisition and Grants Management (OAGM), during fiscal year 2006 CMS awarded contracts valued at about \$3.8 billion. Of that amount, about half represented Medicare claims administration contracts that were not previously subject to FAR. The other half was already covered by FAR and is the category of contract primarily covered by this report.<sup>18</sup>

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## Contract Life Cycle, Contract Types, and Contract Risks

The contract life cycle includes many acquisition and administrative activities. Prior to award, an agency identifies a need; develops a requirements package; determines the method of contracting; solicits and evaluates bids or proposals; and ultimately awards a contract. After contract award, the agency performs contract administration and contract closeout. Contract administration involves the agency monitoring the contractor's progress and processing payments to the contractor. The contract closeout process involves verification that the goods or services were provided and that administrative matters are completed. Also during contract closeout, a contract audit of costs billed to the government may be performed and the agency processes the final invoice with an adjustment for any over- or underpayments.

Agencies may choose among different contract types to acquire goods and services. This choice is the principal means that agencies have for allocating risk between the government and the contractor. Contract types can be grouped into three broad categories: fixed price contracts, cost reimbursement contracts, and time and materials (T&M) contracts. As

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<sup>18</sup> One contract included in our review of payments to contractors was a Medicare claims administration contract. For this contract, we focused only on the portion of the contract funded by MMA, which related to provider customer service activities that were required by MMA.

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discussed below, these three types of contracts place different levels of risk on the government, which the government generally manages through oversight.

- For fixed price contracts, the government agrees to pay a set price for goods or services regardless of the actual cost to the contractor. A fixed price contract is ordinarily in the government's interest when a sound basis for pricing exists as the contractor assumes the risk for cost overruns.
- Under cost reimbursement contracts, the government agrees to pay those costs of the contractor that are allowable, reasonable, and allocable to the contract. The government assumes most of the cost risk because the contractor is only required to provide its best effort to meet contract objectives within the estimated cost. If this cannot be done, the government would provide additional funds to complete the effort, fail to provide additional funds, or terminate the contract. The FAR requires agencies to mitigate risks through adequate government surveillance (oversight) during the performance of the contract. In addition, the contractor must have adequate accounting systems to record and bill costs.
- For T&M contracts, the government agrees to pay fixed per-hour labor rates and to reimburse other costs directly related to the contract, such as materials, equipment, or travel, based on cost. Like cost reimbursement contracts, the government assumes the cost risk because the contractor is only required to make a good faith effort to meet the government's needs within a ceiling price. In addition, since these contracts provide no positive profit incentive for the contractor to control costs or use labor efficiently, the government must conduct appropriate surveillance of contractor performance to ensure efficient methods and effective cost controls are being used.

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## Roles in CMS Contracting Activities

At CMS, OAGM manages contracting activities and is responsible for, among other things, (1) developing policy and procedures for use by acquisition staff; (2) coordinating and conducting acquisition training; and (3) providing cost/price analyses and evaluations required for the review, negotiation, award, administration, and closeout of contracts. Multiple key players work together to monitor different aspects of contractor performance and execute preaward and postaward contract oversight. All but one of the players described below are centralized in OAGM. Project officers are assigned from CMS program offices.

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- Contracting officers are responsible for ensuring performance of all necessary actions for effective contracting, overseeing contractor compliance with the terms of the contract, and safeguarding the interests of the government in its contractual relationships. The contracting officer is authorized to enter into, modify, and terminate contracts.
  - Contracting specialists represent and assist the contracting officers with the contractor, but are generally not authorized to commit or bind the government. Additionally, the contracting specialist assists with the invoice review process.
  - The cost/price team serves as an in-house consultant to others involved in the contracting process at CMS. By request, the team, which consists of four contract auditors, provides support for contract administration including reviewing cost proposals, consultations about the allowability of costs billed on invoices, and assistance during contract closeout.
  - Project officers serve as the contracting officer's technical representative designated to monitor the contractor's progress, including the surveillance and assessment of performance and compliance with project objectives. The project officer also reviews invoices and conducts periodic analyses of contractor performance and cost data.

Within HHS, its cognizant federal agency oversight responsibilities are divided between different agencies and offices. In 2002, HHS designated the National Institutes of Health (NIH) responsible for establishing provisional and final indirect cost rates when requested by other HHS agencies to perform such duties. Other responsibilities, such as monitoring a contractor's compliance with CAS, belonged to the individual HHS agency or office, such as CMS, that primarily works with the contractor. Because certain cognizant federal agency responsibilities at HHS were assigned to CMS, we refer to CMS as the cognizant federal agency. At CMS, the cost/price team was assigned these other cognizant federal agency responsibilities. CMS could also pay another agency to assist it with the necessary oversight. For example, within the Department of Defense (DOD), the Defense Contract Audit Agency (DCAA) performs contract audits, including those required to fulfill DOD's responsibilities as a cognizant federal agency. When requested and for a fee, DCAA will perform contract audits for other agencies.

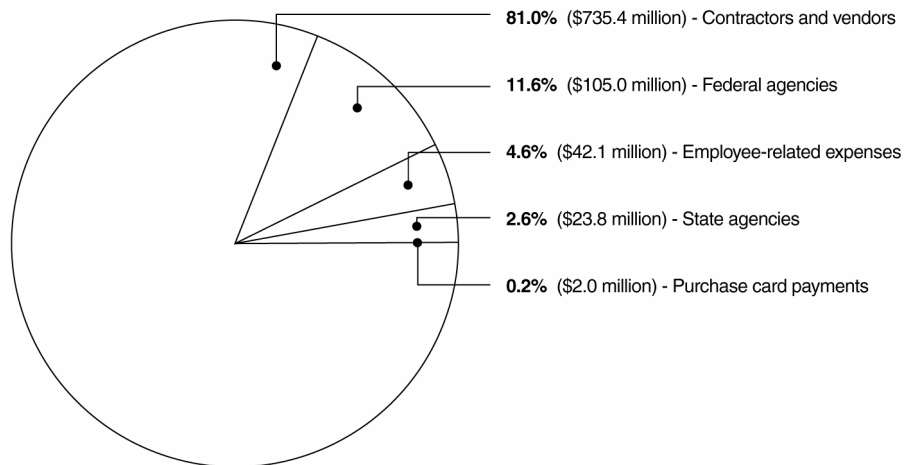
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## CMS Paid Most of the \$1 Billion of MMA Funds to Contractors

Congress appropriated to CMS \$1 billion to fund start-up administrative costs to implement MMA provisions. CMS received \$975 million, and Congress transferred the remaining \$25 million to the HHS Office of the Inspector General (OIG) for oversight of the Part D program, including detecting and preventing fraud and abuse and the design and maintenance of a drug pricing database.<sup>19</sup> CMS's \$975 million appropriation was available for obligation through September 2006. According to CMS financial data, CMS obligated \$974.6 million and, from January 2004 through December 2006, expended over \$908 million,<sup>20</sup> of which about \$735 million or 81 percent was paid to contractors and vendors for a variety of services. Payments were also made for services provided by other federal and state agencies, for CMS employee-related expenses, and for purchase card transactions. Figure 1 summarizes the amounts CMS paid to various recipients.

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**Figure 1: Recipients of CMS's Payments from MMA Funds from January 2004 through December 2006**



Source: GAO analysis of CMS data.

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<sup>19</sup> Because this amount only represented 2.5 percent of the total MMA appropriation, we did not include this \$25 million in our review.

<sup>20</sup> The \$67 million that was not expended as of December 2006 primarily represents amounts obligated to contracts, but not yet paid.

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## Payments to Contractors and Vendors

CMS paid \$735.4 million to over 250 different contractors and vendors. Of this amount, CMS paid about \$521.2 million to 16 major contractors, \$26.7 million to several Medicare contractors serving as fiscal intermediaries<sup>21</sup> and carriers<sup>22</sup> that administer Medicare benefits on behalf of CMS, and an additional \$187 million to over 200 other contractors and vendors. Our assessment of CMS's contracting practices and related internal controls was based primarily on specific controls over the contracts funded with MMA money for the 16 major contractors listed in table 1.

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<sup>21</sup> Fiscal intermediaries administer Medicare claims paid to hospitals and other institutions, such as home health agencies.

<sup>22</sup> Carriers administer the majority of Medicare claims for the services of physicians and other healthcare providers.

**Table 1: Payments to Major Contractors and Vendors from January 2004 through December 2006**

Dollars in millions

<b>Contractors / vendors</b>	<b>Amount</b>	<b>Activity provided<sup>a</sup></b>
NCS Pearson, Inc.	\$153.9	1-800-MEDICARE help line
Palmetto GBA	81.0	1-800-MEDICARE help line <sup>b</sup>
Lockheed Martin Corporation	54.3	Information technology
Ketchum, Inc.	47.3	Outreach/education
CGI Federal	25.7	Information technology
Computer Sciences Corporation	24.8	Information technology
ViPS	24.1	Information technology
Booz Allen Hamilton, Inc.	19.4	Information technology and program support <sup>b</sup>
Government Micro Resources, Inc.	18.0	Information technology
Northrop Grumman Corporation	17.2	Information technology
Iowa Foundation for Medical Care	13.7	Information technology <sup>b</sup>
International Business Machines, Corp.	10.2	Information technology
Z-Tech Corporation	10.2	Information technology
TrailBlazer Health Enterprises, LLC	7.4	Information technology and outreach/education
BearingPoint	7.3	Outreach/education and program support <sup>b</sup>
Maximus, Inc.	6.7	Information technology <sup>b</sup>
Medicare fiscal intermediaries and carriers <sup>c</sup>	26.7	Outreach/education
Other <sup>d</sup>	187.5	Various goods and services
<b>Total</b>	<b>\$735.4</b>	

Source: GAO analysis of CMS data.

<sup>a</sup>We analyzed supporting documentation such as the statements of work for contracts that received at least \$1 million of MMA funding. Based upon this information, we categorized CMS expenditures into various types of activities.

<sup>b</sup>Because we did not categorize contracts or invoices receiving less than \$1 million of MMA funds, this contractor may have performed other activities not specifically noted here.

<sup>c</sup>These contractors, such as Blue Cross Blue Shield, administer Medicare benefits on behalf of CMS.

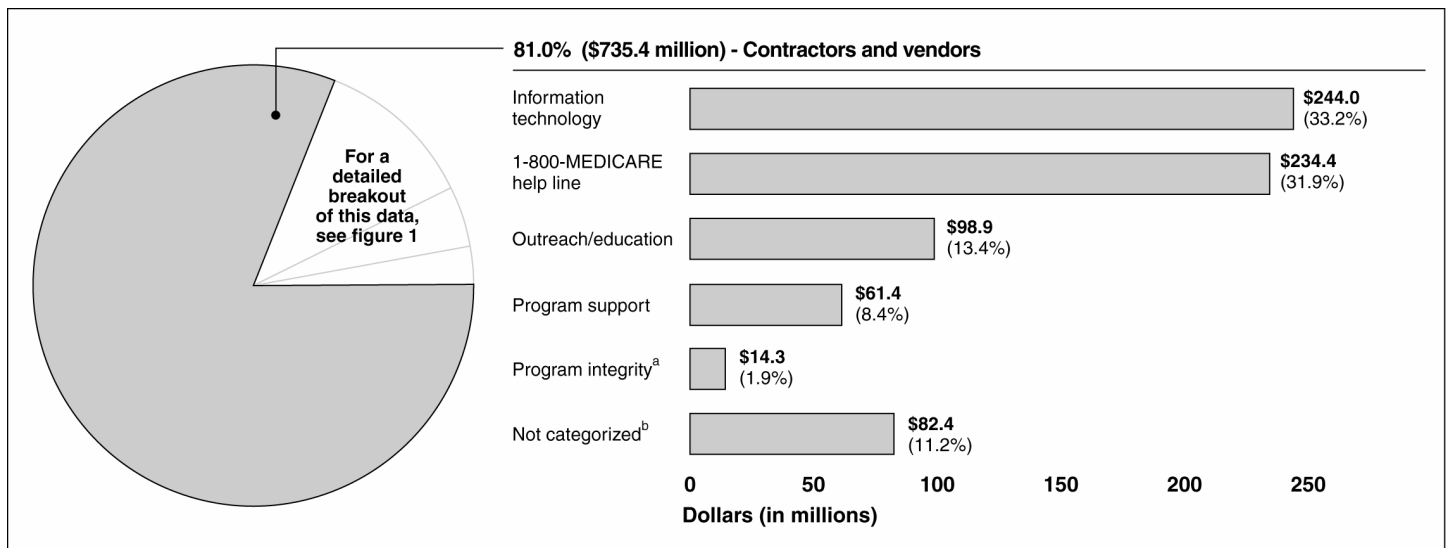
<sup>d</sup>“Other” represents amounts paid to over 200 different contractors and vendors that were not included in our assessment of CMS’s internal controls over contractor payments.

Based on our analysis of contracts and invoices paid with MMA funds, figure 2 summarizes the types of activities provided by contractors and



vendors such as information technology, the 1-800-MEDICARE help line, outreach/education, program support, and program integrity.

**Figure 2: Activities Provided by Contractors and Vendors**



Source: GAO analysis of CMS data.

Note: To categorize payments to contractors by activity, we analyzed supporting documentation such as the statements of work for contracts that received at least \$1 million of MMA funding. Because we did not categorize contracts or invoices receiving less than \$1 million of MMA funds, the amounts reported for each activity could be higher.

<sup>a</sup>“Program integrity” represents amounts paid to contractors and vendors for activities such as antifraud and abuse efforts related to prescription drug benefits.

<sup>b</sup>“Not categorized” represents amounts paid to over 200 contractors and vendors whose total disbursements per contract or invoice were less than \$1 million or were not included in our detailed review of selected contractors.

- Information technology:** CMS paid \$244.0 million for a variety of information technology services including new hardware and software, updates to existing systems, and the development of new systems. For example, CMS used MMA funds to modify its existing contract with CGI Federal (CGI) to update the system that handles Medicare claims appeals so that the system could also handle prescription drug claims. CMS also used MMA funds to modify its contract with Computer Sciences Corporation for the redesign of the beneficiary enrollment and payment system so that the system could also handle prescription drug beneficiaries. CMS also contracted with Iowa Foundation for Medical Care (IFMC) to develop a system to facilitate studies of chronic condition care, as specifically required by MMA.

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- **1-800-MEDICARE help line:** CMS paid \$234.4 million for the operation of the 1-800-MEDICARE help line, a CMS-administered help line used to answer beneficiaries' questions about Medicare eligibility, enrollment, and benefits.<sup>23</sup> Because the help line's call volume significantly increased with the anticipation of the new prescription drug benefit,<sup>24</sup> CMS used MMA funds to expand help line operations and fund a portion of help line costs. CMS contracted with both NCS Pearson (Pearson) and Palmetto GBA (Palmetto) for help line operations.
  - **Outreach/education:** CMS paid \$98.9 million for a variety of outreach and education activities, including \$67.3 million to inform beneficiaries and their caregivers about the changes to Medicare benefits and \$31.6 million to meet the information and education needs of Medicare providers. For example, CMS paid Ketchum, a public relations and marketing firm, \$47.3 million to provide outreach and education to the public. Ketchum assisted with a number of initiatives, including a nationwide bus tour, which traveled to targeted cities across America to promote key messages regarding Medicare prescription drug coverage. To further the television advertising campaign, Ketchum facilitated a number of media buys (the buying of advertising space) for commercials to inform the public about the new prescription drug benefit. CMS paid \$31.6 million to Medicare contractors serving as fiscal intermediaries and carriers that administer Medicare benefits on behalf of CMS. These contractors, such as Blue Cross Blue Shield, assisted with provider customer service as required by MMA to meet the information and education needs of providers.
  - **Program support:** CMS paid \$61.4 million for program support activities to assist with the implementation of the changes to the Medicare program. For example, CMS contracted with Booz Allen Hamilton (BAH) to perform an analysis of the prescription drug industry, review MMA legislative requirements, and develop application

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<sup>23</sup> In December 2004, we reported on the information being provided to beneficiaries through the Medicare help line on eligibility, enrollment, and benefits. See GAO, *Medicare: Accuracy of Responses from the 1-800-MEDICARE Help Line Should be Improved*, [GAO-05-130](#) (Washington, D.C.: Dec. 8, 2004).

<sup>24</sup> In May 2006, we reported on the quality of CMS's communications on the Part D benefit, including communication through the 1-800-MEDICARE help line. See GAO, *Medicare: Communications to Beneficiaries on the Prescription Drug Benefit Could be Improved*, [GAO-06-654](#) (Washington, D.C.: May 3, 2006).

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requirements for the prescription drug plans. CMS also contracted with BAH to support the development of the statements of work for the 1-800-MEDICARE help line contracts, including assisting CMS with monitoring and oversight of the contracts.

- **Program integrity:** CMS paid \$14.3 million for program integrity (antifraud and abuse) activities. For example, CMS paid one contractor \$810,000 to assist CMS as one of the Medicare Drug Integrity Contractors. These contractors assist CMS in antifraud and abuse efforts related to the prescription drug benefits. Other examples of program integrity activities include oversight of the prescription drug card and coordination of benefit payments to prevent mistaken payment of Medicare claims.

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## Payments to Other Recipients

In addition to the \$735.4 million that CMS paid to contractors and vendors, based upon information in CMS's disbursement data and descriptions in interagency agreements and on invoices, we determined that CMS also made payments to other federal agencies, for employee-related costs, to state agencies, and for purchase card transactions.

- **Payments to federal agencies:** CMS paid \$105.0 million to other federal agencies. These payments included \$27.5 million to the U.S. Postal Service for mailing services; \$26.2 million to the Government Printing Office for printing services; \$5.8 million to the Office of Personnel Management for various services, including the development of training courses; and about \$19 million to other HHS divisions for human resources, legal, and other services. CMS also paid about \$24 million to the General Services Administration (GSA) for services including telephone and network services, building renovations, and renovating a leased facility to include a new training center and additional office space.
- **Payments for CMS employee-related costs:** CMS paid \$42.1 million for employee-related costs, including \$38.2 million for payroll costs and \$3.9 million for travel costs. The payroll costs covered about 500 new employees hired in response to MMA and did not include payroll costs for existing CMS employees working on MMA. While these new employees were hired to work in divisions throughout CMS and in various regions of the country, the largest group of employees, 174, was hired to work in CMS's Center for Beneficiary Choices, which is responsible for operations related to the prescription drug plans.

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- **Payments to state agencies:** CMS paid \$23.8 million to state agencies as grants under the State Health Insurance Assistance Program. Under the program (which operates in all 50 states, the District of Columbia, the Virgin Islands, Puerto Rico, and Guam) the agencies provide advisory services to Medicare-eligible individuals and their caregivers. CMS relied on these state agencies to play a significant role in providing counseling and education services on the changes to Medicare, including the new prescription drug benefit.
  - **Payments using purchase cards:** CMS paid \$2.0 million using purchase cards to acquire office supplies, outreach materials, and information technology equipment. An example of outreach materials was \$148,391 that CMS paid for 25,000 paperweights to be distributed at MMA outreach events, such as during the nationwide bus tour. CMS also made a number of audio and video equipment purchases for its television studio. Purchase cards were also used to pay for training such as training for MMA new hires, computer training, and preretirement training.

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## Internal Control Deficiencies over Contracting and Contract Payments Increased the Risk of Waste and Improper Payments

The CMS operating environment created vulnerabilities in the contracting process and increased the risk of waste and improper payments. Over the past several years, resources allocated to contract oversight at CMS have not kept pace with the dramatic increase in contract awards. Additionally, CMS did not allocate adequate funding for contract audits and other contractor oversight activities essential to effectively fulfilling its critical cognizant federal agency responsibilities. Further, risks in CMS's contracting practices made CMS vulnerable to waste. For example, CMS did not always benefit from the effects of competition when awarding contracts. In addition, CMS frequently used a contract type—cost reimbursement—under which the government assumes most of the cost risk. In some cases, this contract type was used by CMS contrary to FAR requirements. In addition, CMS's approval of certain subcontractor agreements may have increased the costs to obtain services.

CMS often applied flawed procedures to review and approve invoices. The flawed procedures were caused, in part, by pervasive internal control deficiencies, such as a lack of policies and procedures that provide sufficient guidance for reviewing invoices and that require adequate supporting documentation for invoices that would enable a review. Additionally, CMS did not sufficiently train its key staff in appropriate invoice review techniques, including identifying risks to the government based on contract type. Further, CMS's payment process, called negative

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certification, did not provide incentive for staff to review invoices, as payments would be made without a certification of review. Finally, CMS did not closeout contracts within time frames set by FAR. With only one OAGM contracting officer tasked with closing contracts, CMS has accumulated approximately 1,300 contracts with a total contract value of about \$3 billion needing closeout as of September 30, 2007.

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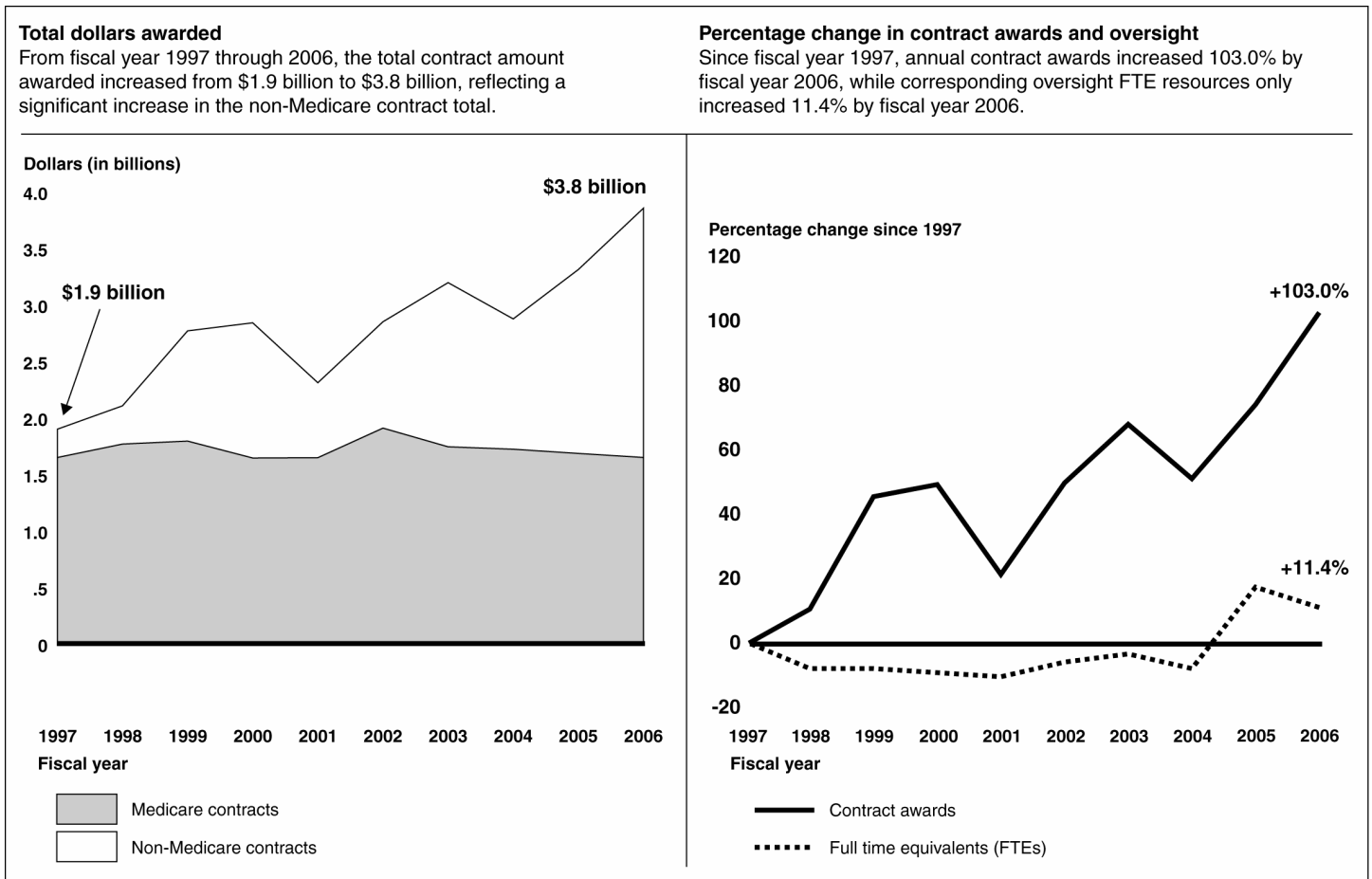
### CMS's Operating Environment Created Vulnerabilities in the Contracting Process

Over the past several years, CMS resources allocated to contract oversight have not kept pace with CMS's increase in contract awards. Additionally, CMS did not allocate sufficient funding for contract audits and other critical contractor oversight activities to fulfill its cognizant federal agency responsibilities. These contractor oversight responsibilities include establishing indirect cost rates with the contractor and verifying that the contractor has the necessary systems and processes in place to accurately bill the government. Moreover, risks in certain contracting practices related to noncompetitive contracts, cost reimbursement contracts, and subcontractor agreements made CMS vulnerable to waste.

### Emphasis on Contract Oversight Did Not Keep Pace with the Increase in Contract Awards

When an organization places sufficient emphasis on accountability or dedicates sufficient management attention to systemic problems, it reduces risk and potential vulnerabilities in operating activities. An organization's control environment, that is, management's overall approach toward oversight and accountability including a supportive attitude towards internal control, provides discipline and structure that influences the way the agency conducts its business. As stated in GAO's standards for internal control, a strong control environment is the foundation for all other elements of internal control. From fiscal year 1997 to 2006, as shown in figure 3, CMS contracting has dramatically increased; however, contract oversight resources have remained fairly constant. Specifically, contract awards have increased from about \$1.9 billion in 1997 to about \$3.8 billion in 2006, an increase of 103 percent, while oversight resources increased from 79 full time equivalents (FTE) in 1997 to 88 in 2006, an increase of about 11 percent. This trend presents a major challenge to contracting award and administration personnel who must deal with a significantly increased workload without additional support and resources.

**Figure 3: CMS Contract Awards and Oversight Resources from Fiscal Years 1997 through 2006**



Source: GAO analysis of CMS data.

### Inadequate Fulfillment of Cognizant Federal Agency Responsibilities

As the cognizant federal agency, CMS was responsible for ensuring that certain critical contractor oversight was performed, including establishing provisional and final indirect cost rates,<sup>25</sup> assessing the adequacy of accounting systems,<sup>26</sup> and monitoring compliance with CAS.<sup>27</sup> CMS did not

<sup>25</sup> 48 C.F.R. 42.703-1 and 42.704(a).

<sup>26</sup> 48 C.F.R. 2.101, 30.202-7, 42.003, 42.101(a)(2), and 9903.202-6.

<sup>27</sup> 48 C.F.R. 9903.201-7.

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have sufficient procedures in place to ensure its cognizant federal agency responsibilities were fulfilled, to readily know the contractors it was responsible for as the cognizant federal agency, or to readily know which contractors were subject to CAS, which would require additional oversight to be performed.

We requested a listing of contractors for which CMS was the cognizant federal agency to determine whether the oversight activities were performed for the contractors in our review. However, because of missing and conflicting data in the information provided by CMS, we independently examined the contract files and spoke with contractors, NIH, DCAA, and CMS officials to determine that at the end of fiscal year 2006, CMS was the cognizant federal agency for 8 of the 16 contractors<sup>28</sup> in our review. The contracts in our review for these 8 contractors had a total value of nearly \$1 billion as of August 2007.<sup>29</sup> As shown in table 2, we found that CMS did not ensure that critical cognizant federal agency duties were performed or that those duties were only partially or insufficiently performed. Table 2 also shows that CMS did not fully ensure that its cognizant federal agency duties were completely performed for any of the 8 contractors.

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<sup>28</sup> These eight contractors were IFMC; Ketchum, Inc.; Maximus; Pearson; Palmetto; TrailBlazer Health Enterprises, LLC (TrailBlazer); ViPS; and Z-Tech. CMS became the cognizant federal agency for Maximus in 2005 and Pearson in 2006.

<sup>29</sup> This total dollar amount reflects only the value of the contracts included in our review. The total contract value for which CMS is the cognizant federal agency is substantially higher and would include other contracts at CMS not included in our review as well as contracts at other agencies.

**Table 2: CMS’s Cognizant Federal Agency Responsibilities**

<b>Contractor</b>	<b>Establish provisional indirect cost rates</b>	<b>Establish final indirect cost rates</b>	<b>Assess the adequacy of accounting system<sup>a</sup></b>	<b>Monitor the adequacy of disclosure statement and/or CAS compliance</b>
IFMC	Yes	No <sup>b</sup>	No	Yes
Ketchum	No	No	Insufficient <sup>d</sup>	No
Maximus	No	No	Yes	No
Pearson	Yes	No	Insufficient <sup>e</sup>	n/a <sup>f</sup>
Palmetto	No	No	Insufficient <sup>e</sup>	Insufficient <sup>g</sup>
TrailBlazer	No	No	Insufficient <sup>d</sup>	No
ViPS	Yes	Partial	Insufficient <sup>d</sup>	No
Z-Tech	Yes	No <sup>c</sup>	No	n/a <sup>h</sup>

Source: GAO analysis of CMS, NIH, and DCAA rate letters and audit reports.

Legend:

Yes – Responsibilities were adequately performed.

No – Responsibilities were not performed.

Partial – Rates were established for at least 1 year between 2004 and 2006, but not all the years necessary.

Insufficient – Responsibilities were not sufficiently performed to fulfill cognizant federal agency oversight.

<sup>a</sup>This responsibility was adequately performed if an assessment of the accounting system was performed and, if necessary a risk analysis was performed showing that a more thorough assessment was not necessary.

<sup>b</sup>DCAA performed an audit of IFMC’s indirect cost rates for 2004 and identified several questioned costs. Additionally, audits of 2005 and 2006 indirect cost rates were recently completed. According to CMS, it has not settled the final indirect cost rates for these years. CMS was instructed by HHS OIG to not finalize indirect cost rates due to an OIG audit that was recently completed.

<sup>c</sup>NIH issued negotiation agreements that included “final rates” for 2004 and 2005. However, the documents do not indicate whether an audit of actual costs was performed.

<sup>d</sup>A preaward survey of the accounting system was performed by DCAA. However, CMS did not provide documentation to show that a risk analysis was performed to determine whether a more thorough accounting system audit was necessary.

<sup>e</sup>At the request of CMS, DCAA performed a preaward accounting system survey. However, despite the volume of contracting, a full accounting system audit was not done.

<sup>f</sup>n/a = not applicable. At the request of another agency, DCAA performed an examination of Pearson’s disclosure statement in 2005, prior to CMS becoming the cognizant federal agency.

<sup>g</sup>At the request of CMS, DCAA performed an examination of the compliance with CAS. In its October 2006 report, DCAA stated that because of significant inadequacies, it was unable to complete its examination. We found no evidence of a follow-up examination.

<sup>h</sup>n/a = not applicable. The contractor was not subject to CAS during the period of our review.



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We found that the listings CMS provided of the contractors for which it was the cognizant federal agency and other contractors were not complete or accurate. CMS provided us with two listings, one prepared in 2005 and another prepared in 2007. The 2005 listing included data fields to record the applicable cognizant federal agency and the status of the cognizant federal agency responsibilities listed in table 2. However, this listing was missing key information for several contractors. For example, there was no information regarding the cognizant federal agency for Ketchum or the status of the cognizant federal agency responsibilities. The 2007 listing included a data field to record the applicable cognizant federal agency, but did not have data fields to record the status of cognizant federal agency responsibilities. In addition, the listings did not clearly or consistently identify whether CMS was the cognizant federal agency. For example, in the 2005 listing, CMS was identified as the cognizant federal agency for IFMC; however, IFMC was not included in the 2007 listing. Subsequently, we verified with CMS officials that CMS was still the cognizant federal agency for IFMC but it was inadvertently excluded from the 2007 listing.

The CAS states that agencies shall establish internal policies and procedures to govern how to monitor contractors' CAS compliance, with a particular emphasis on interagency coordination activities.<sup>30</sup> CMS did not have agency-specific policies and procedures in place to help ensure that its cognizant federal agency responsibilities were properly performed, including the monitoring of contractors' CAS compliance. Of the eight contractors in our review, for which CMS was the cognizant federal agency, seven were subject to CAS<sup>31</sup> at the end of fiscal year 2006. Generally, CMS requested DCAA to perform audit work for some of its cognizant federal agency duties. Further, for HHS, NIH was the agency assigned responsibility for auditing provisional and final indirect rates. However, NIH would not know this work is needed, unless CMS makes a request. In January 2007, one contractor sent a letter to CMS indicating that while CMS had performed some of the cognizant federal agency functions "on an ad hoc basis over the past year," the contractor wanted "to have a more formal relationship in place." The contractor noted that until its indirect cost rates are audited and finalized, it will be "unable to submit final closeout invoices on [its] cost reimbursable work."

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<sup>30</sup> 48 C.F.R. 9903.201-7 (b).

<sup>31</sup> The seven contractors subject to CAS were IFMC; Ketchum; Maximus; Pearson; Palmetto; TrailBlazer, and ViPS. According to IFMC, Ketchum, and TrailBlazer, they were subject to modified CAS.

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Because other agencies rely on the work performed by cognizant federal agencies in their own contracting activities, CMS's failure to ensure its cognizant federal agency responsibilities were fulfilled not only increased risks to CMS, but also to other federal agencies that use the same contractors. For example, we noted that according to one contractor's audited financial statements, as of December 31, 2005, the contractor reported a liability of about \$3.8 million for billing the government more than its actual costs, including about \$2.8 million associated with CMS contracts and \$1.0 million related to a DOD contract. At the time of our review, CMS, as the contractor's cognizant federal agency, had not established its final indirect cost rates for years after 2004, which would be necessary for CMS and DOD to collect the overbilled amounts.

CMS officials and cost/price team members attributed their limited ability to request contract audits—those required by FAR to fulfill cognizant federal agency responsibilities and for the contract closeout process—to the lack of sufficient allocation of funds for these efforts. For example, OAGM provided us with documentation that it requested from CMS management about \$1.2 million for fiscal year 2005 and about \$3.5 million for fiscal year 2006 to pay for proposal evaluations, accounting system reviews, and disclosure statement reviews to help CMS comply with FAR requirements. Despite these requests, OAGM was provided \$30,000 in fiscal year 2005 and \$18,320 in fiscal year 2006. Moreover, no funds were provided for this purpose in fiscal year 2007.<sup>32</sup> Consistent with this, the cost/price team indicated that contract audits often “fall by the way-side” since its resources are limited. Not funding contract audits may limit CMS's ability to closeout contracts, as well as to detect and recover improper payments. Further, based on our review of payments to contractors, the contractors that we identified as having more questionable payments were contractors for which CMS was the cognizant federal agency.

## Risks in Contracting Practices

Contracting and procurement has been identified as an area that poses significant challenges across the federal government. Our work and that of agency inspectors general has found systemic weaknesses in key areas of

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<sup>32</sup> In addition to these allocated resources, OAGM management told us that it can obtain additional funds from CMS program offices to fund specific audits. For fiscal years 2005 through 2007, program offices provided about \$2.3 million, of which \$1.1 million was related to contracting reform activities in fiscal year 2007. CMS also obtained about \$735,000 for fiscal years 2006 and 2007 from the HHS Office of Inspector General for audits that may impact more than one HHS agency.

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acquisition that put agencies at risk for waste and mismanagement.<sup>33</sup> At CMS we found risks resulting from CMS's failure to allocate sufficient resources for effective contract and contractor oversight, and we found that CMS engaged in certain contracting practices that made the agency more vulnerable to waste. For example, CMS did not always take advantage of the benefits of competition and frequently used a contract type—cost reimbursement—that by nature poses more risk to the government because the government assumes most of the cost risk. In addition, CMS approved some subcontractor agreements that may have unnecessarily increased the costs of obtaining those services. We also noted that, when awarding contracts, contracting officers did not always follow advice from others such as the cost/price team and HHS Office of General Counsel that could have mitigated some of these risks.

### **Noncompetitive Contracts**

CMS is generally required to obtain competition for the goods and services it procures.<sup>34</sup> The FAR provides procedures for making price determinations<sup>35</sup> and emphasizes the use of full and open competition in the acquisition process.<sup>36</sup> Because a competitive environment generally provides more assurance of reasonable prices than a noncompetitive one, CMS is exposed to contracting vulnerabilities and potential waste due to practices that limit competition. About 45 percent of the contracts included in our review (representing about \$499.1 million in total contract value) were awarded without the benefit of competition. According to CMS, noncompetitive procedures were used on the contracts in our review because (1) there was an unusual or compelling urgency for the work, (2), the award was made under the Small Business Administration (SBA) 8(a) criteria,<sup>37</sup> or (3) the contracted activities were considered to be a logical

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<sup>33</sup> Contract management at the Departments of Defense and Energy and the National Aeronautics and Space Administration is on GAO's high-risk list, which identifies areas in the federal government with greater vulnerability to fraud, waste, abuse, and mismanagement. See GAO, *High-Risk Series: An Update*, [GAO-07-310](#) (Washington, D.C.: January 2007) and GAO, *Federal Acquisition and Contracting: Systemic Challenges Need Attention*, [GAO-07-1098T](#) (Washington, D.C.: July 17, 2007).

<sup>34</sup> 48 C.F.R. Part 6.

<sup>35</sup> 48 C.F.R. Subpart 15.4.

<sup>36</sup> 48 C.F.R. Part 6.

<sup>37</sup> SBA's 8(a) program is a program for developing small businesses owned by socially and economically disadvantaged individuals. Contracting officers can award contracts below certain dollar thresholds to 8(a) firms without competition.

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follow-on to prior work. While these are permissible reasons to limit competition, in the examples of the noncompetitive contracts described below, CMS's contracting practices may not have sufficiently protected the government's interest in obtaining the best value, in terms of fair and reasonable prices.

- The FAR allows for noncompetitive procedures when there is an unusual and compelling urgency that the government would be seriously injured unless competition is limited. When this exemption is used, an agency prepares a written justification and requests offers from as many potential sources as is practicable.<sup>38</sup> Prior to a noncompetitive award to Maximus ultimately valued at about \$6.5 million, the HHS Office of General Counsel reviewed CMS's justification for other than full and open competition and had concerns with the legal sufficiency of the justification. The Office found that CMS did not demonstrate how it had met the FAR requirement to obtain offers from as many sources as possible or how the agency would be seriously injured if the exemption is not used. Additionally, according to the Office of General Counsel, the urgent and compelling justification did not support procurements in excess of a "minimum amount of time," and suggested limiting the contract to a 5-month term and recompeting the contract during that time. Despite the advice of the Office of General Counsel, 2 days later CMS awarded the contract to Maximus for a 9-month period, never recompeted the contract, and eventually extended the period of performance another 17 months for a total of 26 months.
- For multiple awards to Z-Tech, CMS justified the sole-source noncompetitive awards using SBA's 8(a) exceptions to competition subject to contract value thresholds. To use these exceptions, generally an agency obtains a written authorization from SBA, which places a limit on the dollar value of the contract. For one Z-Tech contract, CMS obtained authorization to award a contract for an amount up to \$3.6 million. SBA also indicated that no other increases would be authorized under this contract and that further increases should be competed under a new contract. Nevertheless, CMS exceeded the SBA-authorized amounts and made awards to Z-Tech totaling about \$4.4 million. Further, we found an agency internal document in a contract file that expressed concern that contract awards to Z-Tech may have been

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<sup>38</sup> 48 C.F.R. 6.302-2(c).

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divided to avoid the dollar threshold that would require competition for 8(a) procurements.

The FAR allows for limiting competition on the issuance of task orders under multiple award contracts if doing so is in the interest of economy and efficiency because it is a logical follow-on to an earlier task order that had been subject to competition.<sup>39</sup> However, the frequent use of the logical follow-on exemption to competition may hinder an agency's ability to obtain the best value for the taxpayer. About 24 percent of the contracts and task orders in our review, with a total value of nearly \$390 million, were issued with no competition as a logical follow-on to a prior task order. Two of these logical follow-on task orders had total values of \$234.6 million and \$67.8 million.

### **Cost Reimbursement Contracts**

One role of the contracting officer is to select the contract type that is in the best interest of the government, places reasonable risk on the contractor, and provides the contractor with the greatest incentive for efficient and economical performance. Cost reimbursement contracts are suitable for use only when uncertainties involved in contract performance do not permit costs to be estimated with sufficient accuracy to use any type of fixed-price contract. We found that about 78 percent of the contracts we reviewed were cost reimbursement contracts. These cost reimbursement contracts had a total contract value of \$1.2 billion. Some CMS officials told us that CMS was a "cost-type shop," meaning that at CMS they prefer cost reimbursement contracts. When cost reimbursement contracts are utilized, FAR requires additional procedures to mitigate the increased risk such as adequate government surveillance.<sup>40</sup> However, as discussed later in this report, CMS did not implement sufficient oversight required for cost reimbursement contracts. In addition, before awarding a cost reimbursement contract, the contracting officer is required by FAR to verify that the contractor has an adequate accounting system for determining costs applicable to the contract,<sup>41</sup> which helps provide the government assurance that the contractor has systems in place to accurately and consistently record and bill costs in accordance with FAR.

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<sup>39</sup> 48 C.F.R. 16.505(b)(2)(iii).

<sup>40</sup> 48 C.F.R. 16.301-3(a)(2).

<sup>41</sup> 48 C.F.R. 16.104(h) and 16.301-3(a)(1).

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During our review of CMS's contract files, we found that contracting officers did not always proactively ensure the adequacy of contractors' accounting systems prior to award of the cost reimbursement contracts.

We also noted instances when CMS knowingly awarded cost reimbursement contracts to a contractor with a deficient accounting system, contrary to the FAR requirement. Specifically, the CMS cost/price team noted numerous significant deficiencies in how Palmetto accounted for costs and determined that Palmetto's accounting system could not adequately account for its direct labor and indirect costs. The cost/price team notified the contracting specialist of the accounting system deficiencies and also stated that "corrections to [Palmetto's] system cannot be completed by the time this contract is awarded." Despite this determination by the cost/price team, the contracting officer awarded two cost reimbursement contracts included in our review to Palmetto with a total contract value of \$157.3 million. Further, the contracting officer awarded a third contract valued at \$3.3 million to Palmetto without verifying whether or not Palmetto's accounting system deficiencies were resolved.

CMS also encouraged a contractor to use a cost reimbursement contract, even though the cost/price team raised concerns regarding the contractor's proposal of certain costs as direct costs and the contractor's ability to accumulate and record direct and indirect costs. Despite these concerns, CMS did not inquire with DCAA about whether or not an accounting system audit had been performed until after the contract was awarded. CMS eventually requested an accounting system audit about a year and a half after contract award. Further, the contractor expressed concerns regarding the cost reimbursement contract type requested by CMS because it did not have prior experience with the contract type. CMS documented in the contract file that "after much deliberation, the contractor realized it was in [its] best interest to accept a [cost reimbursement] contract." In some instances, contractors' inadequate accounting systems inhibited our ability to audit costs billed to the government because the contractors were unable to substantiate the costs billed.

### **Subcontractor Agreements**

While it is not inappropriate for a prime contractor to use subcontractors to achieve the contract's objectives, CMS's approval of some subcontractor agreements may have increased the cost to obtain the services through additional indirect costs and fees. For the contracts we

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reviewed, several of the prime contractors subcontracted for significant volumes of work. For example, on one task order between February 2004 and February 2005, Ketchum billed about \$34.7 million of which about \$33.8 million, or 97 percent, was for subcontractor costs. Furthermore, about \$32.3 million of these costs were related to a single subcontractor. During this same period Ketchum billed only \$59,509 for direct labor (which would include Ketchum's oversight of the subcontractors) yet received about \$694,000 in fees, or over 10 times more than the direct labor Ketchum provided under the contract.

The contracts for the operation of the 1-800-MEDICARE help line are another example of cost increases caused by subcontractor agreements. CMS hired two contractors to operate the help line—Pearson and Palmetto. While each contractor had its own contract with CMS that required them to provide similar services, Pearson and Palmetto subsequently subcontracted with each other, again for the same services. Consequently, the costs to operate the help line were increased through additional indirect costs and fees. Specifically, CMS paid Palmetto an additional \$3.6 million (for indirect costs and fees applied to the Pearson services included with Palmetto's invoices) that may not have been paid absent the subcontract agreement, such as if Pearson provided the services under its own prime contract. In addition, CMS paid Pearson an additional \$630,000 in fees that may not have been paid absent the subcontract agreement.<sup>42</sup>

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### **Pervasive Internal Control Deficiencies Increased the Risk of Improper Payments**

In addition to increased risks associated with CMS's operating environment and certain contracting practices, pervasive internal control deficiencies in its invoice review and approval process increased the risk of improper payments. These deficiencies were caused in part by inadequate policies and procedures for invoice review and insufficient training of key personnel. CMS also did not perform timely contract closeout procedures, including contract audits to determine the allowability of billed amounts.

### **Inadequate Invoice Review and Approval Process**

GAO's standards for internal control state that control activities are the policies, procedures, and mechanisms that address risk and are an integral part of an organization's stewardship of government resources. Effective

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<sup>42</sup> Based on Pearson's invoices, Pearson did not apply indirect costs to the Palmetto services included in its invoices.

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controls are even more important given CMS's risks and vulnerabilities in the contracting process caused by its operating environment. Effective policies and procedures for reviewing and approving contractor invoices help to ensure that goods and services were actually received and amounts billed represent allowable costs, and are comprised of numerous control activities. At CMS, the project officer's role is to review the invoices for technical compliance and accuracy of quantities billed whereas the contracting specialists' role is to determine if the amounts billed comply with contract terms such as indirect cost rates or ceiling amounts.

We found that CMS often used flawed procedures to review and approve contractor invoices. These flawed procedures were caused, in part, by a lack of specific guidance and procedures for the contracting officials to follow as well as insufficient training.

- **Inadequate policies and procedures over invoice review:** CMS's policies and procedures did not provide adequate details on how to review invoice cost elements. For example, CMS's acquisition policy for invoice payment procedures<sup>43</sup> simply states that "the project officer shall certify whether or not the invoice is approved for payment" and "the contracting specialist will review the invoice and (the project officer's certification)." The policy did not give specific instructions or guidance on how to review an invoice or which invoice elements receive the most review given the nature of the services provided or the contract type.
- **Lack of requirements for invoice detail:** CMS did not have requirements for contracting officers to ensure that contractors provide a certain level of detail supporting their invoices to allow responsible CMS personnel to sufficiently review key elements. As a result, CMS often did not require contractors to provide adequate detail in invoices to review billed costs, such as labor charges or travel. For example, some contractors included only lump sum amounts showing the number of hours worked and the associated dollar amount for labor costs but did not provide a list of hours worked by employee or respective labor rates. Without this information, it was not possible for CMS to verify whether the amounts billed corresponded to employees who actually worked on the project. One contractor stated that CMS requested only lump sum amounts for travel with no detailed information or travel receipts. Without this information, CMS could not

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<sup>43</sup> *Acquisition Policy – 16 Subject: Invoice Payment Procedures*, August 2005.



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verify that travel costs were related to the contract or were in accordance with FAR requirements.

- **Insufficient training:** CMS did not sufficiently train staff on how to adequately review invoices, such as identification of risks to the government based on contract type and how to verify labor rates or hours worked. As a result, project officers and contracting specialists were not always aware of their invoice review responsibilities. Some project officers told us that they had only received training “on-the-job.” Further, several staff we interviewed referred to the Project Officer Handbook as a source for guidance on the project officer’s responsibilities. We reviewed this handbook and found that it did not provide any practical guidance on how to review invoices and focused more on the acquisition process (i.e., developing statements of work and preparing acquisition planning documents). In addition, two contracting officers said they attended a 2-hour training sponsored by CMS’s Office of Financial Management (OFM) and that it was helpful in providing guidance on how to review invoices. We also reviewed this training material and found that the training did not sufficiently cover invoice review procedures. The training materials included one slide that indicated that it was the project officers’ responsibility to review invoices, but it did not provide specific examples of invoice review procedures. An OFM official told us that the training was intended to provide detailed guidance on budgeting and appropriation procedures and not invoice review.
- **Lack of incentive to review invoices:** CMS uses a payment process—negative certification—whereby OFM paid contractor and vendor invoices without knowing whether or not such invoices were reviewed and certified. Negative certification is used, in part, to help the agency meet Prompt Payment Act requirements.<sup>44</sup> However, this process is the default for all invoice payments regardless of factors that may increase risk to the agency, including contract type or prior billing problems with the contractor. By contrast, DOD allows for contractors to participate in direct billing, a process similar to negative certification, only if the contractors meet certain criteria such as adequate accounting systems, billing rates established based upon recent reviews, and timely submissions of cost information as required by FAR. CMS’s negative certification process provides little incentive

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<sup>44</sup> Under the Prompt Payment Act and its implementing regulations, an agency’s payment due date for paying an invoice without incurring an interest penalty is generally 30 days after the agency’s receipt of a proper invoice (5 C.F.R. §1315.4(f), (g)).

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for personnel to perform timely reviews of invoices or for reviews to even take place. In our review of contract files, we found that certificates of review by the project officer were not always included in the contract files, and when the certificates were included in the file, they generally did not include evidence to document the review, such as tickmarks or notes, and they were not always signed.

Without sufficient policies and procedures, training, and incentives to review invoices, we found that key staff often used flawed procedures. Contracting officers, specialists, and project officers told us they reviewed invoice costs, such as labor rates for cost reimbursement contracts, based on amounts proposed by the contractor prior to award. However, this practice has little value for cost reimbursement contracts because FAR calls for the payment of actual allowable costs,<sup>45</sup> rather than costs proposed prior to performance of the contract.

Contracting specialists and project officers also told us they reviewed invoices by comparing current invoices to prior months and to burn rates (the rate at which CMS is expending dollars that are obligated to the contract). This procedure provides no assurance that the amounts billed are allowable. Additionally, several project officers told us that they compared invoices to monthly reports prepared by the contractors. This procedure has limited value because it does not involve verifying amounts billed to source documents, such as time sheets, payroll registers, or vendor invoices. Also, when we reviewed the monthly reports, we noted that the reports were not always reconcilable to the invoices, which would hinder the project officer's ability to use the monthly reports in determining the validity of the billed amounts. As described later in this report, we found payments for potentially unallowable costs that could have been identified had proper invoice review procedures been in place.

Further, contracting and project officers did not call for additional oversight procedures when they approved complex subcontractor arrangements such as when a contractor provides the same services as both a prime contractor and as a subcontractor to another contractor. When these types of relationships exist, improper payments or double-billings may go undetected if a contractor bills the same services on both its prime contract invoices (which are reviewed by the government) and its subcontract invoices (which are reviewed by the other prime

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<sup>45</sup> 48 C.F.R. 16.

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contractor). Further, some officials indicated that they relied on contract audits rather than invoice review procedures to catch improper payments. One contracting officer stated that it was not the contracting officer's or specialist's responsibility to review invoices for fraudulent billings, such as double-billings, because such billings would only be found during a closeout audit. While an audit during the closeout process may provide a detective control to identify improper payments after they were made, timely invoice review procedures provide the necessary preventive controls to help ensure that improper payments are not made and would allow CMS to take corrective actions, if necessary. For example, it would be more effective to review the accuracy of labor billings while the contractor is still performing services rather than after the fact during the closeout process, which may be several years later.

## Untimely Contract Closeout

CMS did not perform its contract closeout procedures in accordance with FAR time frames, and until recently, did not have contract closeout policies. The FAR requires agencies to closeout a contract after the work is physically completed (i.e., goods or services are provided).<sup>46</sup> The closeout process is an important internal control, in part, because it is generally the last opportunity for the government to detect and recover any improper payments. The closeout process includes verifying that administrative matters are completed, adjusting provisional indirect cost rates for actual final indirect cost rates, performing a contract audit of costs billed to the government, and making final payments. The complexity and length of the process can vary with the extent of oversight performed by the agency and the contract type. The FAR generally calls for fixed price contracts to be closed within 6 months; contracts requiring the settlement of indirect costs rates, such as cost reimbursement contracts, to be closed within 36 months; and all other contracts to be closed within 20 months.<sup>47</sup> These time frames begin in the month in which the contracting official receives evidence of physical completion of the contract.

According to information provided by OAGM management, as of September 30, 2007, CMS's contract closeout backlog was approximately 1,300 contracts with a total contract value of approximately \$3 billion. The backlog report indicated that 407 contract closeouts were overdue according to FAR timing requirements. Currently, CMS has only one

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<sup>46</sup> 48 C.F.R. 4.804.

<sup>47</sup> 48 C.F.R. 4.804-1(2), (3), and (4).

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contracting officer responsible for the closeout process. Several of the contracts on the backlog list completed contract performance as far back as 1999. CMS established agency-specific contract closeout policies in February 2007. One CMS official stated that prior to the closeout policies, some contracting officials and specialists often passed on contract files to the closeout staff before compiling all required documentation. Because of this, the sole staff member responsible for CMS's contract closeout procedures has to spend time tracking down required documents rather than performing actual closeout procedures.

A key element of the closeout process is the contract audit of costs billed to the government. This audit is used to verify that the contractor's billed costs were allowable, reasonable, and allocable, which is critical for a cost reimbursement contract. This audit is even more important at CMS because of CMS's dependence on cost reimbursement contracts and the reliance placed on the contract audits instead of invoice review procedures. As previously mentioned, CMS has not allocated sufficient resources to ensure contract audits take place. As a result, CMS has limited its ability to detect and recover improper payments from contractors.

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## CMS Made Nearly \$90 Million of Questionable Payments to Contractors

Because of the risks in CMS's contracting practices and pervasive internal control deficiencies, CMS was highly vulnerable to waste and improper payments. Due to this increased risk, we selected contractor transactions to test and found nearly \$90 million of payments to contractors that we questioned because the payments were potentially improper, unsubstantiated, or wasteful. Potentially improper payments include payments for costs that did not comply with the terms of the contract or applicable regulation. Unsubstantiated payments are related to costs that were not adequately supported. Wasteful payments are those for which risks in CMS's contracting practices may have resulted in CMS not obtaining the best value. In some cases, a portion of the questionable payment most likely relates to allowable costs, but due to the facts and circumstances involved, we were unable to determine whether or to what extent the costs were allowable, reasonable, and allocable. As a result, some portion of the total amount of questionable payments we identified ultimately may be determined by CMS to be allowable and therefore not recoverable from the contractor. Table 3 summarizes the questionable payments we identified. Appendix I provides a summary by contractor of the questionable payments we identified.

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**Table 3: Summary of Questionable Payments**

Dollars in millions	
Type of questionable payment	Amount
Costs not compliant with contract terms or regulations	\$24.5
Unsupported contractor costs	62.7
Potential waste	6.6
Less overlapping amounts <sup>a</sup>	(5.0)
<b>Total</b>	<b>\$88.8</b>

Source: GAO analysis of contractor invoices and data.

<sup>a</sup>In certain instances, a portion of a questionable payment may fall into more than one category (i.e., a payment may be both potential waste and not compliant with contract terms). Therefore, to avoid double counting questionable payment amounts, we reduced the gross questionable payment amount by the overlapping amount (\$5.0 million).

Because CMS sometimes used other funding sources in addition to MMA to pay invoices for one contract, we were not always able to identify specific costs that were paid with MMA funds. As a result, the scope of our review extended beyond payments made with MMA funds for some contracts and the amount of questionable payments we identified may not have been paid solely with MMA funds. Given CMS's poor control environment and the fact that our work was not designed to identify all questionable payments made by CMS or to estimate their extent, CMS may have made other questionable payments. Appendix II provides details on the amounts by contractor that we reviewed and the amounts paid with MMA funds.

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### Questionable Payments for Costs Not Compliant with Contract Terms or Regulations

Contracts contain the terms and provisions that set the parameters for allowable costs and the necessary documentation required to support the contractor's billings. For example, contracts may set ceiling limits on the amount of indirect costs a contractor may bill or the amount a contractor may bill for subcontractor costs. Additionally, contracts also incorporate numerous FAR provisions that the contracting officer determines to be applicable to the contract that may require the contractor to follow CAS or may restrict the contractor's travel costs. The contractor is required to bill the government in accordance with the terms of the contract and, as part of its invoice review and approval process, the government's responsibility is to ensure that billings comply with those terms. We identified numerous questionable payments totaling about \$24.5 million that represent potentially improper payments for contractor costs not compliant with the terms of the contract or applicable regulation.

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- **Labor categories outside the terms of the contract – \$1.7 million:** CMS paid CGI, BAH, International Business Machines (IBM), and IFMC for labor categories which were not specifically listed in the terms of the task orders. For example, CGI's task order specified "should the contractor wish to utilize additional GSA IT labor categories...prior CMS approval must be obtained." CGI did not seek and CMS did not give approval for the use of four labor categories, totaling about \$1.3 million. Also, CMS paid BAH about \$208,000 for labor categories that were not specifically listed in the terms of the task order. BAH told us that in its proposal for a modification to the task order, it proposed using the additional labor categories. However, according to the task order, the modification, and other CMS internal contract documents, no additional labor categories were added to the contract. During our review, we also identified payments to IBM and IFMC of about \$231,000 and \$3,000, respectively for labor categories that were not specifically listed in the terms of the task orders. In these four instances, CMS made questionable payments of over \$1.7 million.
  - **Indirect cost rates exceeded contract ceiling rates – \$17.6 million:** CMS paid Palmetto, TrailBlazer, and Maximus for indirect costs that exceeded amounts allowed under indirect cost rate ceilings established in the respective contracts. The contract between CMS and Palmetto included acceptable indirect cost rates, based upon the indirect costs proposed by Palmetto, and applicable ceiling rates. Overhead was not included in the contract as an accepted indirect cost. Nevertheless, Palmetto billed, and CMS paid, at least \$16.2 million of overhead costs. CMS told us that the contract was not modified to include overhead and that "for the government to continue business with [Palmetto] in good faith...[CMS] had to work with Palmetto as it transitioned to becoming CAS and FAR compliant." Palmetto notified CMS that an overhead rate was added to its billing structure, yet CMS did not modify the contract to include the overhead rate. In addition, TrailBlazer billed nearly twice as much as the contract allowed for overhead. During 2006, CMS paid TrailBlazer \$1.4 million for G&A and overhead costs greater than the amount allowed by rate ceilings in the contract between CMS and TrailBlazer. TrailBlazer told us that the indirect cost rate ceilings incorporated into its contract at the time of award were based on its accounting system that, at the time, was not compliant with CAS. Subsequently, in January 2006, when TrailBlazer changed its accounting system to be CAS compliant, the rate ceilings were no longer reflective of its billing structure. In June 2007, TrailBlazer submitted to CMS, its cognizant federal agency, a cost report supporting an increase to its indirect cost rates for 2006. However, CMS did not issue a modification to amend the contract and

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increase the indirect cost rate ceilings. CMS also paid Maximus \$16,000 in excess of its G&A rate ceiling. In these three instances, CMS made questionable payments of over \$17.6 million.

- **Subcontractor costs exceeded approved amount – \$489,000:** CMS paid CGI about \$489,000 for subcontractor costs above the not-to-exceed amount established when CMS approved CGI's use of subcontractors.
- **Improper use of contract type – \$4.5 million:** In February 2005, CMS issued a sole-source, T&M task order to IBM under a commercial Army contract to procure commercial services. Because the FAR prohibited the use of other than fixed-price contracts to procure commercial services at the time the task order was awarded,<sup>48</sup> we questioned the payments to IBM under this task order totaling approximately \$4.5 million.
- **Travel costs exceeding limits – \$11,000:** CMS paid ViPS and CGI for travel costs that exceeded FAR limits incorporated in their contracts. The FAR prohibits contractors from billing for other-than-coach transportation or above set limits for hotels, meals and incidentals, and mileage reimbursement. In several instances, ViPS billed the government \$299 or more a night, in one case as high as \$799 a night, excluding taxes, for hotel stays in Manhattan. During the applicable period, the federal hotel per diem limit for Manhattan was at most \$200 a night. Additionally, the contractor billed the government for business class train travel and amounts that exceeded the meals and incidentals per diem. Each of the 14 ViPS travel vouchers we tested included costs that exceeded allowed amounts. In total, we identified questionable payments of nearly \$10,000 for ViPS travel. CMS also reimbursed CGI about \$1,000 for travel costs in excess of allowed per diem limits.
- **Inappropriate calculation of labor – \$9,000:** CMS paid Ketchum for labor costs that exceeded Ketchum's actual costs for those services on a cost reimbursement contract. Ketchum did not adjust its hourly labor rates to bill for actual labor costs when exempt salaried employees (employees not eligible for overtime compensation) worked more than the standard hours in a pay period. By not adjusting (decreasing) the hourly labor rate to reflect the number of hours actually worked when

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<sup>48</sup> 48 C.F.R. 12.207 (2006).

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an employee worked more than the standard hours, Ketchum charged the government more than its cost—the employee’s salary. For example, if an exempt employee earns \$4,000 for working a 40-hour week, the employee’s hourly rate would be \$100 (\$4,000/40 hours). If that employee worked 50 hours in a week, the employee still earns \$4,000 and the hourly rate would be adjusted to \$80 (\$4,000/50 hours). In this scenario, if the hourly rate were not adjusted, the contractor would have billed \$5,000 (\$100 \* 50 hours) when its actual costs were only \$4,000. Based on the labor transactions we selected for review totaling about \$214,000, we estimated that CMS made about \$9,000 of questionable payments as a result of Ketchum not adjusting its hourly labor rates.

- **Labor costs inappropriately billed – \$20,000:** CMS paid nearly \$20,000 to IFMC for vacation and sick leave that IFMC billed directly to the government. The FAR defines a direct cost as a cost that benefits a single cost objective (e.g., a contract) and an indirect cost as a cost that benefits more than one cost objective.<sup>49</sup> Costs such as employees’ fringe benefits, vacation and sick leave, and other headquarters costs are common indirect costs. IFMC billed vacation and sick leave directly to contracts that an employee worked on only at the time the leave was taken. By billing vacation and sick leave as direct costs, IFMC may have billed more than CMS’s portion of the costs to CMS. For example, if an employee worked on one contract for 11 months and a new contract in the twelfth month and also took leave in the twelfth month, only the contract that the employee worked on in the twelfth month would bear the entire cost of the leave. Had IFMC included its costs associated with vacation and sick leave in its indirect cost rates, these costs would have been proportionally allocated to all of IFMC’s contracts. Therefore, some of the nearly \$20,000 of questionable payments would likely be offset by an increase in the indirect cost rates; however, we could not determine what that amount would be. In total, IFMC billed CMS about \$4.3 million for direct labor from June 2005 through January 2006. Because we only reviewed \$152,000 of labor charges, the total labor billed by IFMC may include additional costs associated with vacation and sick leave.
- **Labor rates in excess of contract terms – \$31,000:** CMS paid CGI for one labor category at rates higher than the rates allowed in its T&M

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<sup>49</sup> 48 C.F.R. 2.101.



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contract, resulting in additional costs of about \$31,000. According to CGI, it intends to issue a credit to CMS for the overbilling.

- **Duplicate billing – \$95,000:** CMS paid about \$95,000 for equipment that CGI billed twice. CGI discovered the double billing for equipment as a result of our audit and subsequently issued a credit to CMS for the double billing.

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### Questionable Payments for Unsupported Contractor Costs

Under a cost reimbursement contract, in which a contractor bills the government for allowable costs to achieve the contract objectives, the FAR requires the contractor to maintain adequate accounting systems and other documentation to support the amounts the contractor bills. For example, the FAR requires contractors to maintain documentation, such as time sheets, pay information, or vendor invoices. Additionally, FAR stipulates that supporting documentation must be maintained for 3 years after the final payment.<sup>50</sup> We identified about \$62.7 million of questionable payments for unsubstantiated contractor costs that were not adequately supported. For each of the questionable payments described below, a portion of the questionable payment most likely relates to allowable costs, but due to the different facts and circumstances involved, we were unable to determine whether or to what extent the costs were allowable, reasonable, and allocable. As a result, some portion of the total amount of questionable payments we identified ultimately may be determined by CMS to be allowable and therefore not recoverable from the contractor.

- **Unsupported contractor costs – \$50.8 million:** CMS paid \$40.6 million to Palmetto for costs that were not adequately supported and \$10.2 million to Pearson for subcontractor costs related to Palmetto that were also not adequately supported.

CMS's cost/price team's review of Palmetto's proposal identified numerous concerns about Palmetto's ability to record and bill costs. Specifically, the cost/price team noted that Palmetto's accounting practices were not compliant with several CAS requirements, its labor system did not distinguish between direct labor and vacation time, and its accounting system did not use indirect cost rates. The cost/price team also indicated that Palmetto was working on addressing these issues, but that it would probably be a lengthy process because of the numerous deficiencies. Despite the concerns about Palmetto's ability

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<sup>50</sup> 48 C.F.R. 4.703.

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to record and bill costs, CMS awarded Palmetto three cost reimbursement contracts, contrary to the FAR requirement<sup>51</sup> that the contractor must have an adequate accounting system for recording and billing costs. In this instance, CMS's decision to award cost reimbursement contracts to a contractor with accounting system deficiencies and CMS's failure to establish Palmetto's indirect cost rates inhibited our ability to audit the costs billed to CMS.

In response to our request for transaction-level detailed reports of costs billed to CMS, Palmetto officials told us that its accounting systems<sup>52</sup> could not generate a report that summarized the costs billed to CMS and that invoices were created manually by allocating costs (direct and indirect) from its cost centers. In addition, we were told that prior to June 2005, Palmetto did not require its salaried employees to use time sheets.

Even though Palmetto told us its salaried employees were not required to use time sheets, Palmetto was able to provide many time sheets to support labor costs it billed. To gain an understanding of the type of information available that Palmetto could provide to support its other direct costs billed, we asked Palmetto to support the costs billed on four invoices. In response, Palmetto provided travel vouchers, subcontractor invoices, and numerous cost center reports and spreadsheets. The travel vouchers and subcontractor invoices supported the amounts billed to CMS. The cost center information represented costs that were directly allocated to the CMS contract. However, Palmetto did not support how it determined the percentages it used to allocate the costs to the CMS contract. Further, when we analyzed the cost center information, we noted several unusual transactions, including depreciation for office and cafeteria furniture, computer equipment, and basketball goals; building and lawn maintenance; and janitorial, security, and recycling services. Because these costs could reasonably benefit more than one cost objective or contract, these types of costs are generally included in a contractor's indirect cost rates rather than billed directly to a contract. Essentially, to audit these costs, all of Palmetto's operations—not just the costs allocated to the three CMS contracts included in our review—would

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<sup>51</sup> 48 C.F.R. 16.104(h) and 16.301-3(a)(1).

<sup>52</sup> According to Palmetto's Chief Financial Officer, in June 2005 Palmetto changed its accounting structure in response to MMA (meaning the requirement for Medicare claims administration contractors to adhere to FAR requirements) and the need to be CAS compliant.

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need to be audited to determine whether the costs were allowable. This type of contractor oversight is normally performed by the cognizant federal agency, which for Palmetto is CMS.

Because of the uncertainties associated with Palmetto's other direct costs (which based on the cost center reports seem to include significant allocations of indirect costs) we concluded that we were unable to audit the other direct costs (excluding travel and subcontractor costs) totaling \$6.1 million billed to CMS prior to June 2005 when Palmetto changed its accounting system to be compliant with CAS.

In addition, we could not verify the allowability and reasonableness of \$34.5 million of indirect costs billed to CMS on the three Palmetto contracts covering 2004 through 2006.<sup>53</sup> On a cost reimbursement contract, indirect costs can be a substantial portion of the total contract cost. FAR requires that 6 months after the close of a year, contractors with cost reimbursement contracts must submit a report of their final costs to their cognizant federal agency.<sup>54</sup> On October 2, 2006, Palmetto submitted to its CMS contracting officer a report of its 2005 final costs. However, CMS may not have realized that Palmetto submitted this report because, according to a letter from CMS's cost/price team to Palmetto dated June 4, 2007, CMS notified Palmetto that its 2004 and 2005 final cost reports were delinquent according to FAR. Further, as of October 2007, Palmetto had not provided to CMS its final cost report for 2006, which is delinquent according to the FAR. Because Palmetto's final cost reports for 2004, 2005, and 2006 have not been audited by CMS its cognizant agency, Palmetto's final indirect cost rates have not been established. Further, provisional indirect cost rates have not been established. Therefore, we did not have support to verify the allowability and reasonableness of the indirect costs that were billed. Moreover, as discussed above, it appeared that indirect costs from Palmetto's cost centers were directly allocated to the CMS contract. As a result, there is considerable risk that CMS may have been billed twice for Palmetto's indirect costs—once as an allocated direct cost and again as an indirect cost.

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<sup>53</sup> This \$34.5 million of questionable payments related to unsupported indirect costs does not include amounts related to overhead that were questioned as costs not compliant with the terms of the contract.

<sup>54</sup> 48 C.F.R. 42.705-1(b).

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The issues described above related to Palmetto's other direct costs and indirect costs also affected the amounts CMS paid to Pearson for Palmetto as a subcontractor. As a result, additional payments totaling \$10.2 million were unsupported.

Because of these numerous concerns described above and lack of documentation to verify amounts billed, CMS made questionable payments totaling \$50.8 million (\$6.1 million, \$34.5 million, and \$10.2 million), which represents the direct and indirect costs that were not adequately supported during our review.

- **Unsupported contractor costs – \$9.7 million:** CMS paid about \$9.7 million to TrailBlazer for costs that TrailBlazer did not adequately support related to a cost reimbursement contract (\$4.8 million)<sup>55</sup> and a portion of its Medicare contract (\$4.9 million) paid with MMA funds.<sup>56</sup> After numerous requests spanning over 7 months, TrailBlazer did not provide us with adequate documentation supporting the amounts billed to CMS for these contracts. For the cost reimbursement contract, the \$4.8 million that TrailBlazer did not adequately support included \$2.4 million of labor costs, \$654,000 of other direct costs, and \$1.8 million of indirect costs. For the labor costs, TrailBlazer told us that only its parent company could provide transaction information, which was never provided. Instead, TrailBlazer provided several reports summarizing labor and other direct costs; however, we could not use these reports because they did not reconcile to the amounts billed to CMS and often included only summary level information. For the indirect costs, generally these costs are supported with provisional or final indirect cost rates that have been audited by a contractor's cognizant federal agency. However, as of October 2007, CMS, TrailBlazer's cognizant federal agency, has not ensured that TrailBlazer's indirect cost rates were audited. TrailBlazer submitted a cost report of its indirect costs for 2006 to CMS in June 2007.

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<sup>55</sup> This \$4.8 million of questionable payments related to unsupported costs does not include amounts related to indirect costs that were questioned as costs not compliant with the terms of the contract.

<sup>56</sup> TrailBlazer, a Medicare contractor that administers claims on behalf of CMS, received a portion of the MMA funds to assist with provider customer service as required by MMA. Medicare contractors, including TrailBlazer, receive advance funding based on budgeted amounts. Three months after the end of a fiscal year, a cost report is submitted to CMS that summarizes actual costs and serves as the basis for final determination of allowable costs.

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For the \$4.9 related to the Medicare contract, TrailBlazer provided a one-page document that summarized the total amount by types of costs, such as salaries, equipment, and fringe benefits. This was not sufficient for us to review the costs.

- **Unsupported indirect costs – \$1.2 million:** CMS paid at least \$1.2 million to Ketchum for indirect costs that were not adequately supported with recently audited provisional or final indirect cost rate information. From May 2004 through October 2006, CMS paid Ketchum for indirect costs based on indirect cost information from 1999. Because FAR calls for indirect cost rates to be based on recent information and established annually, rates based on information from 1999 did not adequately support costs billed in 2004 through 2006. Further, in our review of the contract file, we noted documentation from 2004 that alerted CMS to potential issues with Ketchum’s indirect cost rates—namely, that the rates were too high. In September 2006, Ketchum submitted cost reports for its 2001 through 2005 actual indirect costs. According to Ketchum officials, CMS, as the cognizant federal agency, has recently initiated an audit of this indirect cost rate information to establish final rates for these years.
- **Unsupported labor costs – \$383,000:** Based on the task orders in our review, we estimated that \$383,000 of BearingPoint’s billings for labor and fringe benefits costs were not adequately supported. BearingPoint was unable to provide us with support for certain key elements of the labor and fringe benefits costs it billed on the five task orders in our review.
- **Unsupported transactions – \$463,000:** During our audit, contractors could not adequately support several miscellaneous transactions totaling \$463,000.
  - Palmetto billed CMS for about \$79,000 of labor and about \$323,000 of Kelly Services costs which it did not support with documentation such as time sheets or vendor invoices. Therefore, we were unable to verify the amounts billed.
  - IFMC billed CMS for about \$49,000 of other direct costs such as referral bonuses and placement fees that IFMC did not adequately support. In some cases, IFMC provided invoices for the costs but did not provide support that would enable us to verify that these costs solely benefited and were directly allocable to the CMS contract.

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- BearingPoint billed CMS for about \$5,000 of other direct costs which it did not support with vendor invoices. Therefore, we could not verify the amounts billed.
  - CGI billed CMS for about \$5,000 of other direct costs which it did not support with vendor invoices. Therefore, we could not verify the amounts billed.
  - Maximus billed CMS for about \$2,000 of other direct costs which it did not support with documentation that would allow us to verify that these costs were directly allocable to the CMS contract.
  - **Unsupported contractor costs – \$60,000:** CMS paid BAH more than \$60,000 for intercompany labor costs billed on a cost reimbursement contract that the contractor did not adequately support the rates billed to CMS. For example, on one task order, the intercompany hourly rates, on average, were nearly 14 times higher than the average hourly rate for other BAH employees and almost 6 times higher than the next highest BAH employee. We noted that in a proposal review, CMS’s cost/price team raised a concern that BAH’s proposed intercompany hourly rates were “excessive and unreasonable” and requested BAH to provide support for the proposed rates. Even though BAH refused to provide the support to CMS, CMS awarded the contract. We noted that some of the rates BAH charged for intercompany labor exceeded the proposed rates that were questioned by CMS by, on average, 65 percent. BAH did not provide us support for the rates, but stated that the rates were commercial billing rates priced based on the private sector market.
  - **Unsupported labor costs – \$90,000:** CMS paid Ketchum for labor costs that Ketchum could not support were appropriately allocated to the CMS contract. For cost reimbursement contracts, contractors generally calculate an employee’s hourly labor rate by dividing the employee’s annual salary by 2,080 hours (the standard number of work hours in a year). Ketchum calculated standard hourly labor rates based on 1,880 hours, which increased the hourly rates to account for employees’ leave time. However, this calculation method assigned costs for leave time regardless of whether the leave was taken (when the actual cost occurs). Generally, contractors include the costs of leave time in indirect cost rates, which allocate costs proportionally to all contracts, and when the indirect cost rates are finalized, billed costs are adjusted based on actual costs. Because Ketchum incorporated expected leave time in its hourly labor rates, its billings to CMS would not be adjusted based on its actual costs. Since we were not able to

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verify that the cost of the leave was appropriately allocated to the CMS contracts, we estimated that CMS made almost \$90,000 of questionable payments as a result of Ketchum using 1,880 hours instead of 2,080 to calculate hourly rates. A portion of the \$90,000 would likely be offset by an increase in indirect costs if Ketchum had allocated its leave time to its indirect cost rates.

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## Questionable Payments Related to Potential Waste

During our review, we identified certain contracting practices that increased the risk that CMS did not obtain the best value, thus leading to potential waste. Therefore, we question whether certain contract costs were an efficient use of government resources or might have been avoided. Waste involves the taxpayers in the aggregate not receiving reasonable value for money. Importantly, waste involves a transgression that is less than fraud and abuse. Most waste does not involve a violation of law or regulation but rather relates to mismanagement or inadequate oversight. We identified \$6.6 million of questionable payments for which CMS may not have received the best value. Because waste is generally caused by mismanagement or inadequate oversight, the total amount of questionable payments we identified may not be recoverable from the contractor.

- **Excess subcontractor costs – \$1.4 million:** CMS missed opportunities to save about \$1.4 million associated with costs Z-Tech, IBM, and CGI billed for subcontractors under T&M contracts. According to DCAA, the “T&M payments clause,”<sup>57</sup> generally included in T&M contracts, required that contractors bill the government for subcontractor labor hours at cost. GSA took the position that prime contractors should bill for subcontracted labor at the prime contractor’s own labor rates (regardless of the contractor’s cost). DCAA stated that such a practice places the government at a greater risk of paying costs higher than what prime contractors actually pay without receiving any additional benefits. Further, DCAA noted that the practice incentivizes contractors to maximize profits by subcontracting more work and forces the government to expend additional resources to monitor the subcontracted labor.<sup>58</sup>

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<sup>57</sup> 48 C.F.R. 52.232-7.

<sup>58</sup> The FAR was revised in February 2007 to allow contractors, in certain circumstances such as when the contract was fully competed or was for commercial services, to bill subcontractor labor hours at the contractor’s own labor rates. See GAO, *Defense Contracting: Improved Insight and Controls Needed over DOD’s Time-and-Materials Contracts*, GAO-07-273 (Washington, D.C.: June 29, 2007), pp. 34-36.

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We noted three instances where CMS allowed prime contractors to bill subcontractor labor hours at their own labor rates rather than the lower actual cost. For example, IBM paid about \$1.1 million for its subcontractor labor but billed CMS about \$2.0 million, representing an increase of about \$900,000 or over 80 percent. Likewise, CGI billed CMS about \$420,000, or about 60 percent, more than the amount CGI paid for subcontractor labor and Z-Tech billed CMS about \$91,000, or nearly 35 percent, more than the amount Z-Tech paid for subcontractor labor. According to Z-Tech and CGI, they both notified CMS of their plans to bill subcontractor labor hours under their own labor rates (rather than actual cost) in their contract proposals, which were accepted by CMS. Further, because CMS inappropriately issued IBM's T&M contract off a commercial contract, as previously discussed, the commercial contract did not contain the T&M payments clause. Because CMS did not proactively limit the contractor's billings for subcontractor services to cost, CMS missed an opportunity to save, in total, about \$1.4 million.

- **Additional costs billed by prime contractors – \$4.2 million:** CMS paid Palmetto and Pearson additional costs due to subcontracting arrangements that may have been avoided. As previously mentioned, Palmetto and Pearson each had a prime contract with CMS and subcontracted with each other for similar services. For Palmetto's prime cost reimbursement contract with CMS, Palmetto applied indirect costs and fees to the amounts it billed CMS for the subcontracted work provided by Pearson, which already included Pearson's indirect costs and fees. As a result, two layers of indirect costs and fees were applied to the same services. If CMS had not permitted this subcontracting relationship, the additional layer of indirect costs and fees applicable to Palmetto's billings, totaling \$3.6 million,<sup>59</sup> may have been avoided. Likewise, CMS paid Pearson an additional \$630,000 in fees that may not have been paid absent the subcontract agreement.
- **Unallowable costs included in indirect cost rates – \$953,000:** Prior to September 2005, CMS did not require CGI to exclude independent research and development (IR&D) costs from its indirect

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<sup>59</sup> Palmetto billed CMS a total of \$3.6 million in additional indirect costs (\$3.3 million) and fees (\$318,000) associated with its subcontract with Pearson. The amount related to indirect costs is included in questionable payments for cost not compliant with contract terms (\$16.2 million) and unsupported contractor costs billed by Palmetto (\$50.8 million).



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cost rates. The HHSAR states that IR&D costs are unallowable;<sup>60</sup> however, according to CGI, CMS did not incorporate the HHSAR clause into CGI's contract. CGI agreed to prospectively revise its indirect cost rates to exclude IR&D once they were made aware of the clause. For fiscal year 2005, CMS paid CGI about \$953,000 for IR&D costs that were included in CGI's indirect cost rates. We were unable to calculate the financial impact prior to fiscal year 2005 because CGI did not separately quantify the IR&D component of its indirect rates prior to this point. If CMS failed to include this HHSAR clause in other contracts with CGI or other contractors, this could result in additional waste.

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## Conclusions

CMS management has not allocated sufficient resources, both staff and funding, to keep pace with recent increases in contract awards and adequately perform contract and contractor oversight. This poor operating environment created vulnerabilities in the contracting process. CMS's preaward contracting practices were driven by expediency rather than obtaining the best value and minimizing the risk to the government. Likewise, CMS was not proactive in fulfilling its cognizant federal agency responsibilities, which not only increased its own risk but the risk of other agencies that use the same contractors. Further, significant deficiencies in internal controls over contractor payments, such as inadequate policies, procedures, and training to guide its invoice review process, increased the agency's risk of improper payments. By not timely performing contract closeout audits, CMS may have missed opportunities to detect and recover improper payments. Without immediate corrective actions and appropriate high-level management accountability to fix systemic issues, CMS will continue to be highly vulnerable to waste and improper payments. Moreover, if these issues are not promptly corrected, the Medicare claims administration contracting reform called for in MMA will result in billions of additional dollars of contracting activities being subject to these same deficient contracting practices and internal controls, and exacerbate the potential waste and improper payments.

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## Recommendations for Executive Action

We are making the following nine recommendations to the Administrator of CMS to improve internal control and accountability in the contracting

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<sup>60</sup> 48 C.F.R. 352.216-72(b)(3).

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process and related payments to contractors. We recommend that the Administrator take the following actions:

- Develop policies and criteria for preaward contracting activities including (1) appropriate use of competition exemptions such as logical follow-on agreements, unusual and compelling urgency, and SBA's 8(a) program; (2) analysis to justify contract type selected, as well as, if applicable, verification of the adequacy of the contractor's accounting system prior to the award of a cost reimbursement contract; and (3) consideration of the extent to which work will be subcontracted.
- Develop policies and procedures to help ensure that cognizant federal agency responsibilities are performed, including (1) monitoring CAS compliance, (2) a mechanism to track contractors for which CMS is the cognizant federal agency, and (3) coordination efforts with other agencies.
- Develop agency-specific policies and procedures for the review of contractor invoices so that key players are aware of their roles and responsibilities, including (1) specific guidance on how to review key invoice elements; (2) methods to document review procedures performed; and (3) consideration to circumstances that may increase risk, such as contract type or complex subcontractor agreements.
- Prepare guidelines to contracting officers on what constitutes sufficient detail to support amounts billed on contractor invoices to facilitate the review process.
- Establish criteria for the use of negative certification in the payment of a contractor's invoices to consider potential risk factors, such as contract type, the adequacy of the contractor's accounting and billing systems, and prior history with the contractor.
- Provide training on the invoice review policies and procedures to key personnel responsible executing the invoice review process.
- Create a centralized tracking mechanism that records the training taken by personnel assigned to contract oversight activities.
- Develop a plan to reduce the backlog of contracts awaiting closeout.
- Review the questionable payments identified in this report to determine whether CMS should seek reimbursement from contractors.

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## Agency Comments and Our Evaluation

In written comments on a draft of this report (reprinted in their entirety in appendix III), CMS stated that it would take action on each of our recommendations and described steps taken and others planned to address our recommendations. At the same time, CMS disagreed with some of our findings. Where appropriate, we incorporated changes to our report to provide additional clarification.

In its comments, CMS stated that the contract actions we reviewed were not representative of CMS's normal contracting procedures and stated that the unique circumstances of the implementation of MMA, including the unusually short implementation period, required it to complete an unusually large number of contract actions on the basis of other than full and open competition. We acknowledge that the time frames for implementing MMA added schedule pressures for CMS. At the same time, the compressed time frames and the resulting contracting practices added risk to the contracting process. Many of the findings in our report are a result of the increased risk together with inadequate compensating controls to mitigate risk.

Further, in its comments, CMS disagreed with our finding that it made nearly \$90 million in questionable payments. CMS also stated its belief that it was appropriate for contracting officers to approve invoices for payment based on the information provided with the invoices, and that the payments were interim payments that would be audited at a later date. CMS also stated that the questionable payments we identified were based on our review of the contractors' books and records rather than the invoice amounts. CMS stated that it is premature to conclude that questionable payments exist because it has not conducted a detailed audit of the invoices for the contracts in question.

We disagree. We found amounts that were clearly questionable. Our report also clearly states that in some cases, due to the facts and circumstances involved, we were unable to determine whether or to what extent the costs we questioned were allowable, reasonable, and allocable. As a result, some portion of the total amount of questionable payments we identified ultimately may be determined by CMS to be allowable. However, we also state that given CMS's poor control environment and the fact that our work was not designed to identify all questionable payments made by CMS or to estimate their extent, other questionable payments may have been made.

Further, CMS did not always ensure that contractors provided adequate detail supporting the invoices to allow responsible CMS personnel to

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sufficiently review and approve invoices. Regarding contract audits, CMS had not demonstrated a willingness to allocate the necessary funding; thus audits have not taken place in a timely manner. In addition, while we agree that an audit of contract costs can provide a detective control to help determine whether contractor costs were proper, CMS's reliance on an after-the-fact audit is not an acceptable substitute for the real-time monitoring and oversight of contractor costs—preventative controls—that we recommend in this report. Effective internal control calls for a sound, ongoing invoice review process as the first line of defense in preventing unallowable costs and improper payments. Finally, many of the questionable payments we identified were based on our review of invoices and documentation received by CMS at the time of payment and did not require additional detail from the contractors' books and records. For example, our findings regarding indirect costs, labor categories, and unallowable travel costs could have been identified by CMS with an adequate review of the invoices and information they received from the contractors.

In response to our recommendations to improve controls over its contracting process and related payments, CMS stated in its comments that it has taken or will take the following actions:

- continue to evaluate and update its policies and procedures to make appropriate changes,
- review its policies and criteria for the use of cost reimbursement contracts and the need for approved accounting systems,
- review and update policies and procedures as appropriate and provide training regarding subcontracting,
- develop appropriate procedures to support HHS in its cognizant federal agency functions,
- update its invoice review and payment policies and procedures as necessary,
- develop comprehensive training on the invoice review and approval process,
- require the use of a governmentwide system to track the training taken by personnel assigned to contract oversight,

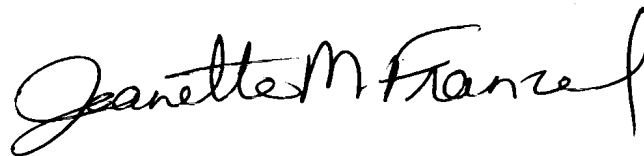
- 
- continue to reduce its backlog of contracts awaiting closeout, and
  - obtain contract audits related to our identified questionable payments and seek reimbursement for any costs found to be unallowable.

In addition, our responses to a number of specific CMS comments are annotated and included at the end of appendix III.

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As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its date. At that time, we will send copies to the Secretary of Health and Human Services, Administrator of the Centers for Medicare and Medicaid Services, and interested congressional committees. Copies will also be available to others upon request. In addition, the report will be available at no charge on the GAO Web site at <http://www.gao.gov>.

If you or your staffs have any questions about this report, please contact me at (202) 512-9471 or [franzelj@gao.gov](mailto:franzelj@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Major contributors to this report are acknowledged in appendix IV.



Jeanette M. Franzel  
Director  
Financial Management and Assurance

# Appendix I: Questionable Payments to Contractors

As shown in table 4, we identified numerous questionable payments totaling nearly \$90 million that represent potentially improper, unsubstantiated, or wasteful payments. In some cases, due to the facts and circumstances involved, we were unable to determine whether or to what extent the costs were allowable, reasonable, and allocable. As a result, some portion of the total amount of questionable payments we identified ultimately may be determined by the Centers for Medicare and Medicaid Services (CMS) to be allowable and therefore not recoverable from the contractor. Given CMS's poor control environment and the fact that our work was not designed to identify all questionable payments made by CMS or to estimate their extent, other questionable payments may have been made.

**Table 4: Questionable Payments by Contractor**

Dollars in thousands

Contractor	Costs not compliant with contract terms	Unsupported contractor costs	Potential waste	Less overlapping amounts <sup>a</sup>	Total
BearingPoint		\$388			<b>\$388</b>
Booz Allen Hamilton, Inc.	\$208	60			<b>268</b>
CGI Federal	1,894	5	\$1,373	\$(631)	<b>2,641</b>
International Business Machines, Corp.	4,720		909	(1,140)	<b>4,489</b>
Iowa Foundation for Medical Care	23	49			<b>72</b>
Ketchum, Inc.	9	1,324		(5)	<b>1,328</b>
Maximus, Inc.	16	2			<b>18</b>
NCS Pearson, Inc			630		<b>630</b>
Palmetto GBA	16,184	51,181 <sup>b</sup>	3,622	(3,304)	<b>67,683</b>
TrailBlazer Health Enterprises, LLC	1,441	9,697			<b>11,138</b>
ViPS	10				<b>10</b>
Z-Tech Corporation			91		<b>91</b>
<b>Total</b>	<b>\$24,505</b>	<b>\$62,706</b>	<b>\$6,625</b>	<b>\$(5,080)</b>	<b>\$88,756</b>

Source: GAO analysis of contractor invoices and data.

<sup>a</sup>In certain instances, a portion of a questionable payment may fall into more than one category (i.e., a payment may be both potential waste and not compliant with contract terms). Therefore, to avoid double counting questionable payment amounts, we reduced the gross questionable payment amount by the overlapping amount (\$5.08 million).

<sup>b</sup>This amount includes \$10.2 million of costs that Palmetto could not adequately support under its subcontract with NCS Pearson.

Because CMS sometimes used other funding sources in addition to Medicare Prescription Drug, Improvement, and Modernization Act of 2003

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(MMA) funds to pay invoices for one contract, we were not always able to identify specific costs that were paid with MMA funds. As a result, the scope of our review extended beyond payments made with MMA funds for some contracts and the questionable payments we identified may not have been paid solely with MMA funds.

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# Appendix II: Scope and Methodology

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To determine how the Centers for Medicaid and Medicare Services (CMS) used the \$1 billion Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA) appropriation, we obtained obligation and disbursement transactions from CMS's financial systems from the period January 2004 through December 2006 that CMS charged against the MMA appropriation. We scanned these data files for obvious omissions or errors in key data fields. To verify the completeness of the files, we reconciled the total obligated amount to the MMA appropriation and reconciled the liquidated obligation amount (a field within the obligation data file) to the disbursement data totals. To determine the recipients of the MMA appropriation, we categorized disbursement data by payee category (contractors, government agencies, state government agencies, etc.) based upon the vendor name in the file. Because CMS recorded about \$536 million of its disbursement to one budget object code, "other services," we were unable to use CMS's budget object codes to determine the services provided by contractors and vendors. Therefore, to categorize expenditures to contractors and vendors by activity (information technology, 1-800-MEDICARE help line, etc.), we reviewed the project titles in CMS's contracts database for all contracts<sup>1</sup> with total disbursements greater than \$1 million; if the contract title was unclear, we reviewed the statement of work in the contract file. We also categorized some additional contracts based on our detailed review of selected contractors.

To identify additional details on the services obtained with MMA funds, we (1) analyzed contract files including statements of work, (2) analyzed interagency agreements, (3) discussed employee-related costs with CMS officials, (4) discussed payments to state agencies with CMS officials overseeing the State Health Insurance Assistance Program as well as certain state agency officials, and (5) analyzed purchase card transaction statements and supporting receipts and discussed these purchases with applicable CMS officials.

To determine whether CMS's contracting practices and related internal controls are adequate to avoid waste and to prevent or detect improper payments, we interviewed CMS officials including contracting officers, contracting specialists, project officers, cost/price team members,

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<sup>1</sup> For the purposes of this report, the term "contract" is generally used to refer to both contracts and task orders issued under contracts. We use the term "task order" when we discuss an issue or a requirement that applies just to a task order and not to the underlying contract.



financial management officials, and Office of Acquisition and Grants Management (OAGM) management about oversight responsibilities; analyzed contract files and invoices; and assessed the sufficiency of CMS policies, procedures, and training. As criteria, we used our Standards for Internal Control in the Federal Government<sup>2</sup> and the Federal Acquisition Regulation (FAR). We focused our internal control work on the contractors that received the most MMA funding, based on the CMS disbursement data. We also selected contractors with other risk factors such as billing or accounting system problems for review. Our approach resulted in the selection of 16 contractors. For these 16 contractors, we then selected contracts to use for our work based on contracts that were funded with at least \$1.5 million of the MMA appropriation.<sup>3</sup> As a result, we nonstatistically selected 16 contractors and 67 contracts with a total contract value of \$1.6 billion. One contract selected was a Medicare contract. Because Medicare contracts were not subject to FAR, we did not include this contract in our internal control review. Therefore we evaluated CMS contracting practices and related internal controls for 66 contracts. Additionally, we obtained from CMS information related to oversight resources from fiscal year 1997 through 2006, the closeout backlog, and its cognizant federal agency duties. We discussed cognizant federal agency oversight activities with and obtained documentation such as indirect cost rate agreements or audit reports from the National Institutes of Health and the Defense Contract Audit Agency.

To determine whether payments to contractors were properly supported as a valid use of government funds, we started with the same 67 contracts we had nonstatistically selected. We further refined the list of 67 contracts based on individual contract values and other risk factors such as contract type to arrive at a selection of 47 contracts for which we reviewed CMS payments to contractors. Because CMS sometimes used other funding sources in addition to MMA to pay invoices for one contract, we were not always able to identify specific costs that were paid with MMA funds. As a result, the scope of our review extended beyond payments made with MMA funds. This nonstatistical selection methodology resulted in a selection of CMS payments to contractors totaling \$595.4 million, of which \$355.5 million was paid with MMA funds. The following table summarizes

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<sup>2</sup> [GAO/AIMD-00-21.3.1](#) (Washington, D.C.: November 1999).

<sup>3</sup> Additionally, if a base contract had multiple task orders—some task orders meeting the \$1.5 million threshold and others not meeting the threshold—we selected all task orders.

the number of contracts and amounts of CMS payments to contractors included in our review, as well as the amount paid with MMA funds.

**Table 5: Contracts and Amounts Included in Our Review of CMS Payments**

Dollars in thousands

Contractor	Number of contracts reviewed	Contract payment amounts	Amount paid with MMA funds
BearingPoint	5	\$4,678	\$4,106
Booz Allen Hamilton	4	7,532	8,185
CGI	6	43,160	25,742
Computer Sciences Corporation	2	23,992	18,877
IBM	2	7,042	9,678
Iowa Foundation for Medical Care	2	19,795	13,544
Ketchum	9	54,442	47,285
Maximus	1	6,317	6,301
Northrop Grumman	4	24,373	16,927
Palmetto	3	182,526	80,158
Pearson	1	180,011	89,893
Trailblazer	2	12,564	7,393
ViPS	2	19,305	18,172
Z-Tech	4	9,634	9,247
<b>Total</b>	<b>47</b>	<b>\$595,371</b>	<b>\$355,508</b>

Source: GAO analysis of contractor invoices and data.

For the 47 contracts, we performed forensic auditing techniques, data mining, and document analyses to select contractor costs billed to CMS to test. Because we selected individual or groups of transactions for detailed testing to determine whether costs were allowable, the amount of contract payments we tested was lower than the amount of payments included in our review shown in table 5. Following is a description of the types of procedures we used to test transactions.

- Labor costs:** We obtained from contractors their databases of hours charged to CMS that included detailed information such as employee name, hours worked per pay period, and pay rate information. Using this information, we selected labor transactions for testing based on quantitative factors such as (1) number of hours worked, (2) dollar amount billed, (3) labor rates, or (4) anomalies in the data. For these nonstatistical selections, we compared the information to supporting

documentation obtained from the contractor, including time sheets and payroll registers and discussed billed amounts with contractor officials.

- **Subcontractor, travel, and other direct costs:** When contractor invoices did not provide sufficient information, we obtained additional information from the contractor, such as databases of transaction-level detail, to select specific transactions based on criteria such as amount billed, vendor names, and potential duplicate payments. We compared our nonstatistical selections to applicable supporting documentation such as vendor invoices, travel vouchers and receipts, and subcontract agreements provided by the contractor.
- **Indirect costs:** We verified the appropriateness of indirect costs billed by recalculating the amounts and comparing the rates billed to provisional and final indirect cost rates and contract ceilings.
- **Analytical procedures:** We performed a variety of analytical procedures including recalculating invoice line items for mathematical accuracy and reviewing invoice amounts for trends and anomalies.

We questioned payments for costs that were potentially improper by assessing whether the costs did not comply with the terms of the contract or applicable regulation (FAR, the Health and Human Services Acquisition Regulation, and Federal Travel Regulation) or that were unsubstantiated because the contractor did not provide adequate support for us to determine whether the costs were allowable. In addition, we questioned payments for which we had concerns that risks in CMS's contracting practices may have resulted in waste. When calculating our questionable payment amounts, where applicable for costs not compliant with contract terms and regulations we added the respective indirect costs that the contractor charged on the item in question. For some of the questionable payments we identified, a portion of the cost is most likely appropriate; however, because of certain facts and circumstances involved, we were unable to determine whether or to what extent the costs were allowable, reasonable, and allocable. Therefore, we questioned the entire amount associated with the uncertainties.

Because CMS sometimes used other funding sources in addition to MMA to pay invoices, the scope of our review extended beyond the payments made with MMA funds. Therefore, questionable payment amounts do not relate exclusively to MMA funds. While we identified some payments as questionable, our work was not designed to identify all questionable payments or to estimate their extent.

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We provided CMS a draft of this report for review and comment. CMS provided written comments, which are reprinted in appendix III of this report. We also discussed with CMS contractors any findings that related to them. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. We conducted our audit work in Washington D.C. and Baltimore, Maryland from March 2006 through September 2007.

# Appendix III: Comments from the Centers for Medicare and Medicaid Services

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



DEPARTMENT OF HEALTH & HUMAN SERVICES

Centers for Medicare & Medicaid Services

Office of the Administrator  
Washington, DC 20201

NOV 6 2007

**DATE:**

**TO:** Jeanette Franzel  
Director  
Financial Management and Assurance  
Government Accountability Office

**FROM:** Kerry Weems   
Acting Administrator

**SUBJECT:** Government Accountability Office Draft Report: "Internal Control Deficiencies Resulted in Millions of Dollars of Questionable Contract Payments," (GAO-08-54)

Thank you for the opportunity to review and comment on the draft Government Accountability Office (GAO) report. The Centers for Medicare & Medicaid Services (CMS) appreciates the insights GAO provides regarding CMS' contracting processes and procedures.

The CMS awards and administers contracts in full compliance with applicable statutes and regulations. We further conduct our contracting operations with the highest degree of integrity.

While our agency will take action on each of the nine GAO recommendations, we assert that the contract actions reviewed by GAO are not, in fact, representative of CMS' normal contracting procedures. The unique circumstances of the implementation of the MMA dictated approaches that are not part of our current contracting procedures. Recognizing the unusually short implementation period, Congress gave CMS the authority to deviate from our usual practices. In fact, 2007 CMS has been exemplary in its use of competitive contracts.

Moreover, we disagree with GAO's conclusion that \$90 million in questionable payments were made to contractors. As we will discuss, CMS has not performed incurred cost audits of the contracts in question nor made a final determination as to the amount of payments owed to the contractors.

In conducting its review, GAO examined a very small sample of CMS' contract actions required to meet the mandates of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA), Pub. L. No. 108-173 (Dec. 8, 2003). There were many unique factors that affected MMA contracting actions during calendar years 2004

See comment 1.

See comment 2.

See comment 1.

See comment 3.

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and 2005, when the Agency was establishing the prescription drug program and implementing other requirements of the MMA.

In the “Conclusion” section of the report, GAO suggests that if the problems noted in its report are not promptly corrected, there may be issues with the Medicare claims administration contracting reform called for in the MMA. The Medicare Administrative Contracts (MAC), which are being awarded on the basis of full and open competition in accordance with the requirements of section 911 of the MMA, fully comply with all applicable statutes and regulations. Safeguards have been put into place to assure that payments to the MACs are appropriate, and that these contracts are administered in strict accordance with applicable contracting requirements.

With respect to the recommendations contained in GAO’s draft report, we are providing the following responses:

**GAO Recommendation Number 1**

**Develop policies and criteria for pre-award contracting activities including (1) appropriate use of competition exemptions such as logical follow-on agreements, unusual and compelling urgency, and SBA’s 8(a) program; (2) analysis to justify contract type selected, as well as, if applicable, verification of the adequacy of the contractor’s accounting system prior to the award of a cost reimbursement contract; and (3) consideration of the extent to which work will be subcontracted.**

**CMS Response**

(1) The first recommendation, regarding the appropriate use of competition exemptions, stems from GAO’s finding that a large percentage of contract actions necessary to implement the MMA were awarded on a noncompetitive basis. Admittedly, CMS was required to complete an unusually large number of contract actions, necessary to meet MMA requirements, on the basis of other than full and open competition. Many of these contract actions were required to implement the prescription drug program. This is an extremely large and complex program. Congressionally mandated dates for the implementation of MMA requirements did not afford CMS sufficient time to compete contracts. A prime example is when CMS had to develop new applications to meet information technology needs. There simply was not sufficient time to develop entirely new systems and applications. Therefore, CMS found it necessary to modify existing systems and applications in order to develop the information technology infrastructure required for the prescription drug program.

Congress recognized the extraordinary circumstances under which CMS would have to award the contracts necessary to implement the programs established in the MMA. Therefore, Congress specifically provided, in section 1857(c)(5) that:

CONTRACTING AUTHORITY – The authority vested in the Secretary by this part may be performed without regard to such provisions of law or regulations

See comment 2.

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relating to the making, performance, amendment, or modification of contracts of the United States as the Secretary may determine to be inconsistent with the furtherance of this title.

The CMS developed a policy for the use of the authority in section 1857(c) to enter into a Medicare Advantage Contract on the basis of other than full and open competition. That policy provided that CMS would only rely upon section 1857(c) 5) if no exceptions to competition under the Federal Acquisition Regulations (FAR) supported a noncompetitive contract award. CMS did not find it necessary to award any Medicare Advantage Contracts pursuant to the authority of section 1857(c)(5) because the FAR provided authority for the noncompetitive contract actions required to implement the MMA.

See comment 4.

On page 23 of the draft report, GAO states “that about 45 percent of the contracts included in our review (representing about \$499.1M in total contract value) were awarded without the benefit of competition.” In fiscal year (FY) 2007, CMS executed 2,489 contract actions resulting in the obligation of \$1.943 billion. Twenty-one of these contracts were awarded on a non-competitive basis under FAR Part 6 in the total amount of \$255 million. Hence, less than 1 percent of CMS’ contract actions and approximately 13 percent of the contracted dollars, were awarded on a noncompetitive basis, under FAR Part 6 in FY 2007. For FY 2008, the Department has established a goal that at least 75 percent of awarded dollars, or 60 percent of contract actions, be processed on the basis of competition. CMS substantially exceeds these goals. Indeed, CMS has an exceptional record for awarding contracts on the basis of full and open competition.

See comment 4.

On page 25 of the draft report, GAO also states, “About 24 percent of the contracts and task orders in our review, with a total value of nearly \$390 million, were issued with no competition as a logical follow-on to a prior task order.” In FY 2007, CMS only awarded 10 task orders as a logical follow-on, which is .004 percent of all contract actions, in the total amount of \$2.3 million, or approximately 1 percent of the total dollars obligated. The extent of use of logical follow-on task orders to implement the MMA in the contracts sampled is not indicative of CMS’ award of logical follow-on task orders in general.

In addition, GAO recommends that CMS develop policies and criteria for the award of contracts pursuant to the Small Business Administration’s 8(a) program. CMS is required to utilize small disadvantaged businesses in the 8(a) program to the maximum extent possible. The Department of Health and Human Services (DHHS) has established a goal that CMS award 5.5 percent of its total contract dollars to 8(a) firms, and there is an expectation that CMS will significantly exceed that goal. The 8(a) program is the cornerstone of the Government’s initiatives for increasing small business participation in Government contracting. Thus, pursuant to the authority of the 8(a) program, we are required to award contracts to small and disadvantaged businesses to the maximum possible extent.

The fundamental procedures for the award of non-competitive contracts are contained in the FAR and the Department of Health and Human Services Acquisition Regulation

Page 4 – Jeanette Franzel

(HHSAR). We also have in place CMS-specific procedures for use of competition exemptions. For example, Justifications for Other Than Full and Open Competition (JOFOC), which are based upon unusual and compelling circumstances, must be reviewed by the Office of the General Counsel to ensure they are legally sufficient. In addition, CMS' Competition Advocate reviews and approves all JOFOCs over \$500,000. These measures provide added safeguards to assure that CMS awards contracts on the basis of competition to the maximum possible extent.

We agree with GAO that the award of contracts on a competitive basis is essential to assuring the integrity of the contracting process. Therefore, we will continue to evaluate and update our policies and procedures and make appropriate changes. We will also address competitive contracting requirements in our training to assure that CMS' acquisition workforce is fully aware of the requirements for the competitive award of contracts.

(2) On page 25 of the draft report GAO states: "We found that about 78 percent of the contracts we reviewed were cost reimbursement contracts. These cost reimbursement contracts had a total contract value of \$1.2 billion." However, for the contracts in question, CMS had to utilize cost-reimbursement contracts.

The FAR section 16.202 states that a firm-fixed-price contract is appropriate for supplies or services which are to be acquired on the basis of "reasonably definite functional or detailed specifications." The prescription drug program was an entirely new initiative. CMS had no prior experience with this program. CMS did not have extensive expertise among its staff for implementing the prescription drug program. CMS could not develop statements of work for MMA requirements that were definite enough to allow for a fixed-price contract. In FY 2007, approximately 30 percent of CMS contract actions, accounting for just over 50 percent of the total dollars awarded, were for cost-reimbursement type contracts. Given the constant changes associated with the Medicare program, and the difficulty in precisely defining the Agency's needs, we believe these figures show that CMS employs cost-reimbursement type contracts to an appropriate extent.

On page 26 of the draft report, GAO notes instances where it believes CMS awarded contracts to entities that did not have an acceptable accounting system. In fact, based upon past audits by the Defense Contract Audit Agency (DCAA), CMS believes that the contractors in question, including Palmetto, IFMC, Ketchum, NCS Pearson, Trailblazer, and ViPS, did have acceptable accounting systems. Hence, the information in the chart on page 20, to the effect that these contractors did not have approved accounting systems, is not accurate. CMS Contracting Officers are sensitive to the requirement that a contractor have an acceptable accounting system prior to being awarded a cost reimbursement contract.

The use of the correct contract type is critical to the award of a contract, as is assuring that a contractor has an approved accounting system. Therefore, in response to GAO's recommendations, we intend to review our policies and criteria for the use of cost

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reimbursement contracts and the need for approved accounting systems and will update those policies as necessary. We will also provide appropriate training to CMS staff.

(3) With respect to subcontracted work, CMS awarded contracts that resulted in extensive subcontracting efforts because the skills required to perform the work were not readily available from a single contractor. GAO questioned the utilization of subcontractors under certain CMS contracts. For example, on page 27 of the draft report, GAO indicates that under a task order with Ketchum, 97 percent of the total costs went to subcontractors. The report further questions the level of profit paid to Ketchum.

However, a principal purpose of the task order was to secure television advertising time for the Medicare education campaign. Hence, this work had to be subcontracted. Television advertising requires upfront payments. Ketchum financed millions of dollars to make certain that CMS' advertisements ran on network and cable television. Ketchum, therefore, assumed an inordinate amount of costs in disbursing funds for television advertising on the Government's behalf, as well as risk in performing this work. The fact that Ketchum financed these millions of dollars and oversaw the process of getting the ads to the airwaves was the rationale for determining that a 2 percent profit factor for subcontracted work was fair and reasonable.

The GAO also questioned subcontracting arrangements between Pearson and Palmetto for the operation of the Medicare call center. However, the volume of calls received from beneficiaries increased exponentially as a result of the implementation of the prescription drug and Medicare Advantage programs. It was necessary for Pearson and Palmetto to work in tandem and to balance calls between their respective operations in order to provide acceptable service to the public.

We appreciate the importance of assuring that contract work is performed appropriately and that profits are not excessive. We will therefore review and update our policies and procedures regarding the review and approval of subcontracts as appropriate. We will also provide training to staff on subcontracting requirements.

**GAO Recommendation Number 2**

**Develop policies and procedures to govern CMS' cognizant federal agency responsibilities, including (1) monitoring CAS compliance, (2) mechanism to track contractors for which CMS is the cognizant federal agency, and (3) coordination efforts with other agencies.**

**CMS Response**

We agree that processes and procedures for performance of cognizant Federal agency responsibilities need to be strengthened. We have had ongoing discussions with DHHS regarding audit cognizance. Section 42.003 of the FAR provides that "the cognizant Federal agency normally will be the agency with the largest dollar amount of negotiated contracts." Based upon discussions with DHHS, we understand that DHHS is the

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“cognizant Federal agency.” CMS is an Operating Division of DHHS and is not a “Federal agency.” Hence, CMS cannot independently perform cognizant Federal agency contracting functions.

Part of the confusion surrounding audit cognizance stems from section 342.705 of the HHSAR, which provides that “The Division of Financial Advisory Services of the National Institutes of Health has the authority to establish indirect cost rates, fringe benefit rates, etc., for use in contracts and grants awarded to commercial organizations.” To date, NIH generally has not been able to perform this function.

Therefore, we recognize the need to work with DHHS to establish policies and procedures for the performance of cognizant Federal agency functions. To the extent that CMS is designated to perform functions in supporting DHHS as the cognizant Federal agency, we will develop appropriate procedures for monitoring Cost Accounting Standard (CAS) compliance and for coordinating efforts with other agencies.

**GAO Recommendation Number 3**

**Develop agency-specific policies and procedures for the review of contractor invoices so that key players are aware of their roles and responsibilities, including (1) specific guidance on how to review key invoice elements; (2) methods to document review procedures performed; and (3) consideration to circumstances that may increase risk, such as contract type or complex subcontractor agreements.**

**CMS Response**

The CMS Acquisition Policy Number 16, entitled “Invoice Payment Procedures,” was issued in August 2005. The purpose of this Acquisition Policy was to promulgate specific policies and procedures for invoice review and payment. CMS will review Acquisition Policy Number 16 and will amend its policies and procedures as necessary to assure that key players understand their roles and responsibilities. Also, CMS is coordinating with the Department in the sharing of “best practices” which may lead to the development of Department-wide standardized policies and procedures for invoice review and payment. We recently provided comprehensive training to CMS Project Officers regarding invoice review and will continue our efforts to train both Project Officers and Office of Acquisition and Grants Management contracting staff.

It should be noted, however, that with respect to our most significant contracts, such as contracts with the MACs, Program Safeguard Contractors, Quality Improvement Organizations, and Qualified Independent Contractors, as well as the Health Insurance General Ledger Accounting System, the contact center and significant IT contracts, we have established very comprehensive processes and procedures for the review and approval of invoices. We have gone so far as to develop software that is used to analyze the invoices under most of these contracts. A preponderance of the funds that CMS obligates to contracts is expended under these major contracting efforts.

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**GAO Recommendation Number 4**

**Prepare guidelines to contracting officers on what constitutes sufficient detail to support amounts billed on contractor invoices to facilitate the review process.**

**CMS Response**

As stated above, CMS will review its current invoice review policies and procedures and will make appropriate revisions. Moreover, CMS intends to develop a guide for both Project Officers and Contracting Officers for the review and approval of contractor invoices. This will provide for more consistency in the review of invoices.

**GAO Recommendation Number 5**

**Establish criteria for the use of negative certification in the payment of contractor's invoices to consider potential risk factors, such as contract type, the adequacy of the contractor's accounting and billing systems, and prior history with the contractor.**

**CMS Response**

The negative certification process was established to assure that CMS would meet the requirements of the Prompt Payment Act. Under this process, Project Officers and Contracting Officers were nonetheless required to thoroughly review invoices. We are constantly providing training and direction to Project Officers and Contracting Officers assure that they review invoices appropriately. We recognize, however, that absent documentation supporting the approval of invoices, there is no evidence to support the extent and appropriateness of invoice review and approval. Therefore, we intend to revise our procedures to develop a documentation trail that will support that an invoice was appropriately reviewed and may properly be paid.

**GAO Recommendation Number 6**

**Provide training on the invoice review policies and procedures to key personnel responsible for executing the invoice review process.**

**CMS Response**

As previously mentioned, we intend to develop comprehensive training for Project Officers and Contracting Officers on invoice review policies and procedures. A training session was held recently on October 16, 2007, which was attended by approximately 300 Project Officers. The training addressed the review and approval of invoices.

**GAO Recommendation Number 7**

**Create a centralized tracking mechanism that records the training taken by personnel assigned to contract oversight activities.**

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**CMS Response**

A Government-wide system was recently established for tracking the training taken by personnel assigned to contract oversight activities. The Acquisition Career Management Information System (ACMIS) is a centralized tracking mechanism used by all Federal agencies for maintaining the training records of personnel assigned to contract oversight activities. ACMIS provides a database on the training, education, certification, and other information on an agency's acquisition workforce including both Project Officers and Contracting Officers. Use of ACMIS is mandatory for all CMS Project Officers and contracting staff.

**GAO Recommendation Number 8**

**Develop a plan to reduce the backlog of contracts awaiting closeout.**

**CMS Response**

The CMS developed a plan for reducing the backlog of contracts awaiting closeout and successfully implemented the plan in FY 2007. It proved to be a very effective strategy for reducing CMS' backlog of contracts awaiting closeout. At the beginning of FY 2007, CMS had 590 contracts that were overdue for closeout. By the end of FY 2007, CMS had reduced the number of contracts overdue for closeout to 407. This was a 30 percent reduction in contracts that were overdue for closeout. In FY 2008, CMS fully expects to continue this trend and further reduce the backlog.

**GAO Recommendation Number 9**

**Review the questionable payments identified in this report to determine whether CMS should seek reimbursement from contractors.**

**CMS Response**

This recommendation stems from GAO's finding that CMS made nearly \$90 million in questionable payments to contractors. We disagree with this finding. The contracts in question were cost-reimbursement contracts. The payments to the contractors were interim payments under those contracts. The payments were made strictly on the basis of the contractor invoices and the documentation provided in connection with those invoices. Based upon the information the contractors provided in support of the payments, it was entirely appropriate for the Contracting Officers to approve the invoices for payment.

GAO found that the payments were questionable not based upon its review of the invoices, which served as the Contracting Officers' basis for the approval of the interim payments, but instead based its review upon the contractors books and records. CMS will obtain audits of all costs claimed for reimbursement under these contracts and will obtain

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the repayment of any costs that are found to be unallowable. It is premature to conclude that CMS has made any questionable payments, as there has not yet been a determination of the proper amount of reimbursement under these contracts.

In fact, it is entirely likely that most of the contractors invoiced costs will be found to be allowable. Specifically, on page 36 of the draft report, GAO questioned \$16.2 million in indirect costs paid to Palmetto on the basis that the costs exceeded the contract ceiling rates. On pages 39-40 of the draft report, GAO questioned \$40.6 million that was paid to Palmetto but GAO found that there were issues with Palmetto's ability to record and bill costs. These two cost elements comprise more than over 60 percent of the costs which GAO questioned.

The questioned costs were incurred in the performance of Palmetto's call center contract. This contract was critical to the successful implementation of MMA. Palmetto served as one of the main sources of information for Medicare beneficiaries regarding the prescription drug benefit and the Medicare Advantage program. The Contracting Officer had documentation from DCAA finding Palmetto's accounting system to be adequate for the award of a cost-reimbursement contract. In performing this contract, Palmetto was in the process of converting from the accounting practices under its Medicare intermediary and carrier contracts to an accounting system that complied with the Cost Accounting Standards (CAS). In making the conversion to a CAS compliant system, costs that were previously charged directly under the intermediary and carrier contracts were moved into indirect cost pools, and other changes were made to Palmetto's methodologies for accumulating and reporting costs.

The Contracting Officer was aware of the transition that Palmetto was undergoing in becoming CAS compliant and was working in good faith to assist Palmetto in making the conversion to CAS. The Contracting Officer reviewed the invoices, in concert with program staff, and approved the payments based upon the information presented in the invoice. The conversion to a CAS compliant system does not mean that the charges to the contract were inappropriate. CMS will audit the costs incurred by Palmetto and will finalize indirect cost rates for the periods in question for both contractors, and will recoup any costs that are determined to be unallowable.

On page 42 of the draft report, GAO indicates that Trailblazers did not provide adequate documentation to support \$10.3 million of invoiced costs. However, the Contracting Officer has been addressing this issue with Trailblazers, and believes that, in fact, Trailblazers does have documentation in support of these costs. Hence, we do not believe that these costs are questionable.

In other instances where CMS was aware that a contractor had billed inappropriate amounts to its contracts, CMS took action to recover amounts erroneously billed. For example, when CMS became aware of a MAXIMUS' billing in excess of the indirect ceiling rates specified in the contract as is discussed on page 36 of the draft report, CMS immediately issued a demand letter to MAXIMUS requesting reimbursement of the inappropriately charged amount.

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In sum, we intend to review all of the contractor costs that have been questioned in the report in the course of our audits of the contractors, and to seek reimbursement as appropriate. However, CMS appropriately approved the interim payments under the contracts in question.

Thank you again for your review of CMS' MMA-related contract actions. In response to GAO's recommendations, we will review and amend our processes and procedures, as appropriate. We will further assure that CMS contracting staff receives appropriate training on such policies and procedures.

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## GAO Comments

1. See “Agency Comments and Our Evaluation” section.
2. The contracting authority CMS referred to (Section 1857(c)(5)) applies specifically to Medicare Advantage contracts (formerly referred to as Medicare+Choice contracts) and prescription drug plan contracts and does not apply to the types of contracts included in our review.
3. As stated in our report, CMS paid \$735.4 million of its MMA funds for start-up administrative costs to contractors and vendors. Our review included 67 contracts with a total contract value of \$1.6 billion, of which \$508.4 million was paid with MMA funds. Our sample covered about 69 percent of the MMA funds paid to contractors and vendors.
4. CMS compared the percentages of noncompetitively awarded and logical follow-on task orders that were included in our review to statistics it calculated for its 2007 contracting actions. The percentages related to our review are not comparable to the statistics CMS presented primarily because the percentages were calculated differently. Our percentages were based solely on the number of contracts in our review and included several years. Our calculation showed that 45 percent of contracts in our review were awarded without the benefit of competition. CMS used fiscal year 2007 contracts, which were outside the scope of our review, to arrive at a total of \$255 million awarded on a noncompetitive basis for that fiscal year. Furthermore, CMS calculated the percentage of noncompetitive awards for fiscal year 2007 by comparing the number of noncompetitive contracts to the total number of contract actions. Contract actions likely include contract modifications, and one contract could have several modifications. For example, one of the large information technology contracts in our review had over one hundred modifications (contract actions).
5. CMS stated that it had to use cost reimbursement contracts because MMA was an entirely new initiative. We present the statistics about cost reimbursement contracts to add perspective due to the increased risk associated with these types of contracts.
6. As stated in our report, CMS awarded cost reimbursement contracts to Palmetto despite CMS’s own cost/price team’s determination that the contractor had numerous accounting system deficiencies. The chart CMS referred to is our summary of CMS’s fulfillment of its cognizant federal agency responsibilities. The chart illustrates instances in which CMS did not sufficiently assess the adequacy of the contractor’s accounting system. The chart is not intended to present a conclusion about the adequacy of the contractors’ accounting systems.

7. Because certain cognizant federal agency oversight responsibilities at HHS were assigned to CMS, as discussed in our report, we believe it is CMS's obligation to ensure that those responsibilities are performed. In addition, we added wording to our report to clarify that we refer to CMS as the cognizant federal agency in this report because HHS delegated cognizant federal agency responsibilities to CMS.
8. We modified our report to clarify that we reviewed CMS's *Acquisition Policy – 16 Subject: Invoice Payment Procedures*, August 2005.
9. CMS issued the demand letter to Maximus as a result of our preliminary audit findings.



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# Appendix IV: GAO Contact and Staff Acknowledgments

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## GAO Contact

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## Acknowledgments

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