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RECOVERY AUDITING

Reducing Overpayments,
Achieving Accountability,
and the Government Waste
Corrections Act of 1999

Statement of David M. Walker, Comptroller General of the
United States



Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to discuss H.R. 1827 the Government Waste Corrections Act of 1999, and its relationship to the long-standing issues of government accountability for use of public monies and overpayments and the role of recovery auditing in identifying and recovering overpayments. To put these issues in perspective, in fiscal year 1998, federal executive departments and agencies contracted for about \$173 billion in goods and services. The Department of Defense (DOD) spent about \$115 billion, or about two-thirds of this amount. In addition to direct contracting, federal agencies indirectly pay out many more billions of dollars annually for health care, education, and agricultural programs.

One of the most important issues facing the government today is the need for greater accountability in managing the finances of our national government. It is a significant problem at many agencies, and one that has been the subject of frequent reports by us and others. One key aspect of the problem is the difficulty the government has in assuring proper payment of all its bills while avoiding overpayments.

My testimony, today, will discuss the dimensions of the overpayment problem, our past work on the DOD recovery auditing demonstration program, and the Government Waste Corrections Act of 1999. My comments on the bill reflect my belief that there are three principles that should guide a recovery auditing program. First, there should be meaningful incentives for agencies to want to participate in the program and make it work. Second, there should be adequate safeguards to ensure that the program is implemented in a manner intended by Congress and that preserves the integrity of the congressional appropriations process. Third, there should be transparency in the conduct of the program—that is, there should be evaluation and reporting of program implementation, in this case, to include how the recovered amounts are used. In the context of these three principles, I will suggest opportunities to strengthen H.R. 1827.

Results in Brief

Significant financial management system weaknesses, problems with fundamental recordkeeping and financial reporting, incomplete documentation, and weak internal controls continue to prevent the government from effectively managing many of its operations. Significant among these problems is the inability of federal agencies to determine the full extent of improper payments that occur in major programs and that are

estimated to involve billions of dollars annually. Within the billions of dollars of improper payments is an unknown amount of overpayments.

While neither the federal agencies nor we have a good estimate of the extent of overpayments that occur each year, given the poor state of the financial and accounting records, we expect that they are significant. We know, for example, that between fiscal year 1994 and 1998, contractors returned about \$4.6 billion in overpayments to DOD.

At the direction of Congress, DOD is conducting a recovery auditing demonstration program to identify overpayments for subsistence, medical, and clothing items purchased in fiscal years 1993 through 1995. We evaluated the demonstration program and concluded that the concept of recovery auditing offers the potential to identify overpayments. However, we found that implementation problems have limited the program's success. As of June 1999, the recovery auditing contractor had identified about \$29 million in overpayments made to suppliers on purchase volumes of roughly \$6 billion. Collections by DOD amount to \$2.6 million. While authorized to do so, DOD has been slow to expand the use of recovery auditing beyond the initial demonstration program.

Although contractors are sometimes overpaid, under current law, they are not required to inform the government of the overpayment or to return the money prior to the government issuing a formal demand letter¹ requesting repayment. In effect, the overpayment provides an interest free loan to the contractor. Contractors should be required to notify the government of overpayments when they become aware of them and to return the money promptly upon becoming aware of the overpayments. If they do not return the money promptly, there should be some economic consequence.

Given the large volume and complexity of federal payments, federal agencies need to concentrate on paying bills properly in the first place. However, recognizing that some overpayments are inevitable, they also need to adopt best practices to quickly identify and recover them. The Government Waste Corrections Act of 1999 offers an opportunity to use recovery auditing to identify overpayments and the factors contributing to overpayments. We support the objectives of this important legislation. Some commercial companies have used recovery auditing for many years as one mechanism to identify and recover overpayments. The extent to

¹A demand letter is a formal notification to the contractor that it owes the government money.

which recovery auditing is applicable to the full range of federal agency overpayments, however, remains an open question since its use in the federal government has been limited. Thus, we strongly support provisions of the bill that provide for model programs. In this way, the government can assess the applicability of recovery auditing to different types of payments and develop best practices for its use on a wider scale. In our view, with this use of model programs, plus strong monetary incentives, it would be unnecessary to mandate recovery auditing across the government.

The Committee may also want to reexamine the provisions in the bill relating to reallocation or use of overpayment recoveries. While financial incentives are critical to the program's success, incentives that are too large are unnecessary and may undermine the program by creating inappropriate incentives to making accurate and timely payments in the first place. The Committee may want to provide for a substantial portion of the recoveries to be returned to the Department of the Treasury.

Poor Financial Controls Are a Governmentwide Problem

Across the government, improper payments, including overpayments, occur in a variety of programs and activities, including those related to contract management, federal financial assistance, and tax refunds. Reported estimates of improper payments total billions of dollars annually. Such payments can result from incomplete or inaccurate data that are used to make payment decisions, insufficient monitoring and oversight, or other deficiencies in agency information systems and internal controls. The risk of improper payments is increased in programs involving (1) complex criteria for computing payments, (2) a significant volume of transactions, or (3) an emphasis on expediting payments. The reasons for improper payments range from inadvertent errors to fraud and abuse.

The full extent of improper payments, however, is unknown because many agencies have not estimated the magnitude of improper payments in their programs, nor have they considered this issue in their annual performance plans. The use of appropriate performance measures relating to improper payments can provide a management focus on reducing related losses. For example, the Department of Health and Human Services has reported a national estimate of improper payments in its Medicare fee-for-service benefits since fiscal year 1996. For fiscal year 1998, the Department reported estimated improper payments of \$12.6 billion, or more than 7 percent, of Medicare fee-for-service benefits—down from about \$20 billion, or 11 percent, reported for fiscal year 1997 and \$23.2 billion, or

14 percent, for fiscal year 1996. An analysis of improper Medicare payments helped to implement several initiatives intended to reduce improper payments. These initiatives significantly reduced the incidence of improper Medicare payments.

DOD Is a Case for Recovery Auditing

Because it spends more contracting for goods and services than all other agencies combined, it is particularly important that DOD have sound controls to ensure that contract payments are proper, accurate, and timely. In recent years, our reports have identified hundreds of millions of dollars in improper DOD payments, interest expense on late payments, and other financial management problems. For example, in March 1994, we reported that during a 6-month period in fiscal year 1993, the Defense Finance and Accounting Service (DFAS) in Columbus, Ohio--a principal DOD contract paying activity--processed \$751 million in payments returned by defense contractors.² Our examination of about one-half of these checks disclosed that about 78 percent represented overpayments by the government. We also found that while some contractors returned overpayments, others did not. In one case, an overpayment of \$7.5 million was outstanding for 8 years. We estimated that the government lost interest on the overpayment amounting to nearly \$5 million.

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

²DOD Procurement: Millions in Overpayments Returned by DOD Contractors (GAO/NSIAD-94-106, Mar. 14, 1994).

DOD Is Taking Actions to Address Payment Problems

DOD is taking steps to address its payment problems. Its initiatives include testing and adopting some best practices. In the long term, it is developing procurement and payment systems that will be linked by sharing common data. This linkage is expected to allow one-time entry of contract data critical to making correct payments. In the meantime, DOD is enhancing its current technologies to further automate the payment process, testing streamlined payment practices, and making efforts to reduce the number of contract fund citations. But, as we state in our recent high-risk report,³ it is likely to be many years before DOD gets its payment problems under control.

Additional Steps Could Be Taken

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

First, we believe defense contractors, and for that matter, all contractors should be required to promptly notify the government of overpayments when they become aware of them. If they do not return the money promptly, there should be some economic consequence. This seems simple enough, but currently a contractor is not required to tell the government that it has been overpaid, nor is it required to return an overpayment until the government becomes aware of the overpayment and issues a demand letter for repayment. Many contractors do promptly return overpayments; however, some do not. While we know the amount of overpayments that contractors have returned to the government, we do not know how much they are still keeping. Thus, as pointed out earlier, the true magnitude of the overpayment problem is not known. In this regard, we will shortly begin a review to assess the extent to which defense contractors are retaining and not promptly returning overpayments to the government.

Second, we believe that all federal agencies should take advantage of best practices that commercial companies use to identify and recover overpayments. One such practice is the use of recovery auditing procedures. Clearly, the government's focus should be on paying its bills properly in the first place. However, for both private industry and government agencies, some payments are processed incorrectly for a variety of reasons. For instance, vendors make pricing errors on their

³Major Management Challenges and Program Risks, Department of Defense (GAO/OCG-99-4, Jan. 1999).

invoices, forget to include discounts that have been publicized to the general public, neglect to offer allowances and rebates, or miscalculate freight charges. Government payment activities may also neglect to take discounts to which they are entitled. These mistakes, when not caught, result in overpayments. Identifying and recovering these types of overpayments is referred to as recovery auditing.

Recovery Auditing Offers Potential to Identify and Recover Overpayments

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

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

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

We reviewed the program and concluded that recovery auditing offers potential to identify overpayments, but implementation problems hindered DOD from fully realizing the benefits of the program.⁴ As of August 1998, PRGI had identified \$19.1 million in overpayments. However, recoveries of overpayments amounted to only \$1.9 million, in large part, because vendors

⁴Contract Management: Recovery Auditing Offers Potential to Identify Overpayments (GAO/NSIAD-99-12, Dec. 3, 1998).

took issue with some of the overpayments. This caused the recovery process to virtually stop for 8 months while the DSCP reviewed the merits of the vendors' issues. DSCP concluded that the claims of overpayment were valid. However, according to the contracting officer, his letter of final decision regarding vendors' indebtedness has not been issued. PRGI continues to identify overpayments. As of June 1999, according to PRGI, it had completed 90 percent of its work and identified \$29.3 million in overpayments made to suppliers on purchases of roughly \$6 billion. Collections by DOD as of June 1999 amounted to \$2.6 million. According to PRGI, its overpayment identification rate under the demonstration program is 0.48 percent of purchases reviewed, which is consistent with its experience with new private sector clients before corrective measures are implemented. PRGI told us that, as corrective measures are implemented, the overpayment rate typically drops to about 0.1 percent of purchases reviewed.

PRGI has also made recommendations to DFAS and DSCP to reduce future overpayments, but, at the time of our review, DOD had not implemented them.

These recommendations ranged from reprogramming payment systems to providing contracting personnel additional training to help them determine price reasonableness.

DOD Is Slow to Use Recovery Auditing Techniques

DOD has been slow to embrace recovery auditing. For example, in House Report 105-532, which related to a bill providing for fiscal year 1999 DOD authorizations, DOD was directed to use recovery auditing by selecting at least two commercial functions within its working capital fund and issuing a competitive request for proposal by December 31, 1998. We found, however, that DOD had not done either.⁵ While DOD issued an August 1998 memorandum encouraging the use of recovery auditing, and some activities have expressed an interest, no contracts had been awarded at the time we completed our work in March 1999. In June 1999, we checked with the recipients of the August 1998 memorandum and, with the exception of the U.S. Transportation Command, which had just entered into a contract for recovery auditing services, no other contracts had been awarded. The Defense Commissary Agency said it has completed a statement of work,

⁵Contract Management: DOD Is Examining Opportunities to Further Use Recovery Auditing (GAO/NSIAD-99-78, Mar. 17, 1999).

and plans to have a contract by July 30, 1999. The Defense Logistics Agency told us it issued a solicitation on May 28, 1999, to expand the use of recovery auditing from the demonstration program in place at DSCP to its other four supply centers. The Defense Logistics Agency said it plans to have a contract by August 31, 1999. Each of the services and the Defense Information Services Agency also expressed an interest in recovery auditing, and they are evaluating whether to use it.

Issues Related to Using Recovery Auditing

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

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

Finally, it is important to recognize that the DOD demonstration program has been focusing primarily on identifying overpayments related to subsistence, medical, and clothing purchases. While representing an audit base of about \$7.2 billion, it is only a small part of the dollars spent on contracts by DOD each year. Most DOD expenditures are for purchases of major weapon systems. The applicability of recovery auditing to these types of contract payments is, at this time, unclear.

The Government Waste Corrections Act of 1999

The Government Waste Corrections Act of 1999 (H.R. 1827) would require the use of recovery auditing by federal agencies and provide incentives to improve federal management practices with the goal of reducing overpayments.

We believe the act is a positive step in the government's effort to reduce overpayments and to obtain timely identification and recovery of overpayments. The act addresses recommendations we made in our recent report on DOD's demonstration program. One recommendation was to give the head of an executive agency the option to perform recovery auditing with internal staff, by contract or through a combination of both internal staff and contract.

We are also pleased to see that the bill requires a contractor to provide periodic reports with recommendations on how to mitigate overpayment problems and that as a part of the agency's management improvement program, the agency is to give first priority to addressing problems that contribute to overpayments.

Finally, the proposed act allows applicable appropriations to be reimbursed for costs incurred by government activities in supporting recovery audit efforts and provides other incentives to support the use of recovery auditing. These features should help eliminate some of the implementation problems we saw in the demonstration program.

Suggestions to Improve the Bill

While we are positive toward the concept of recovery auditing and its potential for application in the federal government, the government's experience with the use of recovery auditing has been limited. Thus, we think it is a good idea to mandate further model programs in civilian and defense agencies to determine the applicability of recovery auditing and to develop best practices for their use governmentwide. In conducting the mandated model programs—at least five are currently provided for in the bill—there should be sufficient diversity in where recovery auditing is modeled to adequately test the concept among the different types of payment activities. Beyond the mandated model programs, we believe that the use of recovery auditing should, at least for the time being, be available, but not mandated, for other federal agencies. Currently, the bill provides for mandatory use of recovery auditing by federal agencies, in addition to the model programs.

The Committee may also want to reexamine the provisions in the bill relating to reallocation or use of overpayment recoveries. While financial incentives are critical to the program's success, incentives that are too great are unnecessary and may undermine the program by creating inappropriate incentives to making accurate and timely payments in the first place. The Committee may want to provide for a substantial portion of

the recoveries to be returned to the Treasury. We will be happy to discuss further technical comments with the Committee staff.

Conclusions

In closing, Mr. Chairman, federal agency managers have a fiduciary responsibility relating to, and are accountable for, the proper use of federal funds. Our work has shown that, in certain cases, these responsibilities are not being exercised adequately and the result is billions of dollars a year in improper payments, a portion of which represent overpayments that may never be recovered. Federal agencies need to achieve more effective control over their payment processes. The causes of the payment problems are varied and many are long-standing. The solutions can be found in the effective use of technology, the establishment of sound internal control and payment processes, and the wise use of human capital. If federal agencies do not effectively tackle these challenges, they will continue to risk erroneously paying contractors and perpetuating other financial management problems. Effectively addressing them, however, will require investment and sustained commitment by top-level management.

Recovery auditing, which has a long-standing track record in the private sector, offers a low-risk opportunity to identifying and recovering overpayments. We strongly support provisions of H.R. 1827 that provide for model recovery auditing programs. In this way, the government can assess the applicability of recovery auditing to different types of payments and develop best practices for its use on a wider scale. In our view, with the use of model programs, plus strong monetary incentives, it would be unnecessary to mandate recovery auditing across the government. There may also be opportunities to employ novel servicing arrangements, such as creating a “center of excellence” in a federal agency to provide leadership to other agencies in implementing recovery auditing.

The keys to the successful execution of governmentwide recovery auditing programs are (1) meaningful incentives for agencies to want to participate in the program and make it work, (2) adequate safeguards to ensure achieving congressional intent and the proper use of appropriations, and (3) transparency in the conduct of the program.

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

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